Department of the Treasury
Office of Thrift Supervision

Transmittal

November 20, 1997 **Number: 185**

Risk-based capital for assets sold with recourse and direct credit substitutes would be standardized to better reflect actual risk under a rule proposed jointly by the Office of Thrift Supervision (OTS), the Comptroller of the Currency, the Federal Reserve Board and the Federal Deposit Insurance Corporation.

The attached proposed rule would apply to:

- Assets sold with recourse, and
- Direct credit substitutes

In both cases, a depository institution retains or assumes credit risk for assets owned by other investors.

Currently, certain types of recourse arrangements and direct credit substitutes require different amounts of capital even though the risk of credit loss related to these arrangements may be the same. The agencies propose to rectify this inconsistency by establishing the same risk-based capital requirements for assets with equivalent risks, regardless of whether the risk stems from assets sold with recourse or direct credit substitutes.

In addition, to better reflect the level of credit risk related to recourse transactions and direct credit substitutes that are part of securitization structures, the agencies are proposing to adopt a "multilevel" capital approach for assigning risk weights to various types of positions in such securitizations. For traded positions in asset securitizations, the proposal would use ratings issued by commercial rating agencies. An asset-backed security with a "AAA" rating would be risk-weighted at 20 percent. For positions rated below "AAA", two alternative approaches are presented for comment: a "modified gross-up" approach that would apply a 50 percent risk weight to the value of the assets underlying the security and a "face value" approach which would apply a 100 percent risk weight to the face amount of the security. This proposed rule, however, would not change the current treatment of high quality mortgage-related securities (generally, qualifying AAA and AA mortgage-related securities) under the OTS risk-based capital rule.

For assets not traded, the proposal sets forth three possible approaches for determining an asset's credit risk. One of them would require institutions to obtain individual credit ratings by two different rating agencies. The second approach would allow institutions to use generic credit risk standards established by the banking agencies for categories of assets. The third approach would use historical loss data. The agencies invite comment on all aspects of the rule.

The agencies intend that if the proposal is adopted as a final rule, any resulting increased capital requirements for banks and thrifts would apply only to transactions consummated after a final rule goes into effect. Any resulting decrease in the capital requirements would apply immediately.

The notice of proposed rulemaking was published in the November 5, 1997, edition of the *Federal Register*, Vol. 62, No. 214, pp. 59943-59976. On November 20, 1997, the agencies also published corrected tables for the ratings benchmark approach to correct formatting errors in the charts initially published in the November 5, 1997, edition of the *Federal Register* on pages 59958-59959. Please use the attached revised charts in developing your comments on the ratings benchmark approach. The revised charts were published on November 20, 1997, in the *Federal Register*, Vol. 62, No. 224, pp. 62233-62237.

Written comments must be received on or before February, 3, 1998, and should be addressed to: Manager, Dissemination Branch, Records Management and Information Policy Division, Office of Thrift Supervision, 1700 G Street, N.W., Washington, DC 20552. Comments may be faxed to 202/906-7755, or e-mailed to: public.info@ots.treas.gov.

For further information contact:

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Robert A. Kazdin	202/906-5759
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Ellen Seidman
Director
Office of Thrift Supervision

Attachment

federal register

Wednesday
November 5, 1997

Part II

Department of the Treasury

Office of the Comptroller of the Currency

12 CFR Part 3

Federal Reserve System

12 CFR Parts 208 and 225

Federal Deposit Insurance Corporation

12 CFR Part 325

Department of the Treasury

Office of Thrift Supervision

12 CFR Part 567

Risk-Based Capital Standards; Recourse and Direct Credit Substitutes; Proposed Rule

DEPARTMENT OF THE TREASURY

Office of the Comptroller of the Currency

12 CFR Part 3

[Docket No. 97–22]

RIN 1557–AB14

FEDERAL RESERVE SYSTEM

12 CFR Parts 208 and 225

[Regulations H and Y; Docket No. R–0985]

FEDERAL DEPOSIT INSURANCE CORPORATION

12 CFR Part 325

RIN 3064–AB31

DEPARTMENT OF THE TREASURY

Office of Thrift Supervision

12 CFR Part 567

[Docket No. 97–86]

RIN 1550–AB11

Risk-Based Capital Standards; Recourse and Direct Credit Substitutes

AGENCIES: Office of the Comptroller of the Currency, Treasury; Board of Governors of the Federal Reserve System; Federal Deposit Insurance Corporation; and Office of Thrift Supervision, Treasury.

ACTION: Joint notice of proposed rulemaking.

SUMMARY: The Office of the Comptroller of the Currency (OCC), Board of Governors of the Federal Reserve System (Board), Federal Deposit Insurance Corporation (FDIC), and Office of Thrift Supervision (OTS), (collectively, the agencies) are proposing revisions to their risk-based capital standards to address the regulatory capital treatment of recourse obligations and direct credit substitutes that expose banks, bank holding companies, and thrifts (collectively, banking organizations) to credit risk. The proposal would treat direct credit substitutes and recourse obligations consistently and would use credit ratings and possibly certain other alternative approaches to match the risk-based capital assessment more closely to a banking organization's relative risk of loss in asset securitizations.

The agencies intend that any final rules adopted in connection with this proposal that result in increased risk-based capital requirements for banking organizations apply only to transactions consummated after the effective date of the final rules.

DATES: Comments must be received on or before February 3, 1998.

ADDRESSES: Comments should be directed to:

OCC: Written comments may be submitted electronically to regs.comments@occ.treas.gov or by mail to Docket No. 97–22, Communications Division, Third Floor, Office of the Comptroller of the Currency, 250 E Street, SW., Washington, DC 20219. Comments will be available for inspection and photocopying at that address.

Board: Comments, which should refer to Docket No. R–0985, may be mailed to the Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC 20551, to the attention of Mr. William Wiles, Secretary. Comments addressed to the attention of Mr. Wiles may be delivered to the Board's mail room between 8:45 a.m. and 5:15 p.m., and to the security control room outside of those hours. Both the mail room and the security control room are accessible from the courtyard entrance on 20th Street between Constitution Avenue and C Street, NW. Comments may be inspected in Room MP500 between 9 a.m. and 5 p.m. weekdays, except as provided in § 261.8 of the FRB's Rules Regarding Availability of Information, 12 CFR 261.8.

FDIC: Written comments should be addressed to Robert E. Feldman, Executive Secretary, Attention: Comments/OES, Federal Deposit Insurance Corporation, 550 17th Street, N.W., Washington, D.C. 20429. Comments may be hand delivered to the guard station at the rear of the 550 17th Street Building (located on F Street), on business days between 7:00 a.m. and 5:00 p.m. (Fax number: (202) 898–3838; Internet address: comments@fdic.gov). Comments may be inspected and photocopied in the FDIC Public Information Center, Room 100, 801 17th Street, N.W., Washington, D.C., between 9:00 a.m. and 4:30 p.m. on business days.

OTS: Send comments to Manager, Dissemination Branch, Records Management and Information Policy, Office of Thrift Supervision, 1700 G Street, N.W., Washington, D.C. 20552, Attention Docket No. 97–86. These submissions may be hand-delivered to 1700 G Street, N.W., from 9:00 a.m. to 5:00 p.m. on business days or may be sent by facsimile transmission to FAX number (202) 906–7755; or by e-mail: public.info@ots.treas.gov. Those commenting by e-mail should include their name and telephone number. Comments will be available for inspection at 1700 G Street, N.W., from 9:00 to 4:00 p.m. on business days.

FOR FURTHER INFORMATION CONTACT:

OCC: David Thede, Senior Attorney, Securities and Corporate Practices Division (202/874–5210); Dennis Glennon, Financial Economist, Risk Analysis Division (202/874–5700); or Steve Jackson, National Bank Examiner, Treasury and Market Risk (202/874–5070).

Board: Thomas R. Boemio, Senior Supervisory Financial Analyst (202/452-2982); or Norah Barger, Assistant Director (202/452–2402), Division of Banking Supervision and Regulation. For the hearing impaired only, Telecommunication Device for the Deaf (TDD), Diane Jenkins (202/452–3544), Board of Governors of the Federal Reserve System, 20th and C Streets, NW, Washington, DC 20551.

FDIC: Robert F. Storch, Chief, Accounting Section, Division of Supervision, (202/898–8906), or Jamey G. Basham, Counsel, Legal Division (202/898–7265).

OTS: John F. Connolly, Senior Program Manager for Capital Policy (202/906–6465), Supervision Policy; Michael D. Solomon, Senior Policy Advisor (202/906–5654), Supervision Policy; Fred Phillips-Patrick, Senior Financial Economist (202/906–7295), Research and Analysis; Robert Kazdin, Senior Project Manager (202/906–5759), Research and Analysis; Karen Osterloh, Assistant Chief Counsel (202/906–6639), Regulation and Legislation Division, Office of Thrift Supervision, 1700 G Street, N.W., Washington, D.C. 20552.

SUPPLEMENTARY INFORMATION:

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I. Introduction and Background

A. Overview

The agencies are proposing to amend their risk-based capital standards to clarify and change the treatment of certain recourse obligations, direct credit substitutes, and securitized transactions that expose banking organizations to credit risk.

This proposal would amend the agencies' risk-based capital standards to:

- Define "recourse" and revise the definition of "direct credit substitute";[1]
- Treat recourse obligations and direct credit substitutes consistently for risk-based capital purposes; and
- Vary the capital requirements for traded and non-traded[2] positions in securitized transactions according to their relative risk exposure, using credit ratings from nationally-recognized statistical rating organizations[3] (rating agencies) to measure the level of risk.

Additionally, this proposal discusses and requests comment on two possible alternatives to the use of credit ratings for non-traded positions in securitized transactions, either or both of which may be adopted, in whole or in part, in the final rule. These alternatives would:

- Use criteria developed by the agencies, based on the criteria of the rating agencies, to determine the capital requirements; or
- Permit institutions to use historical loss information to determine the capital requirement for direct credit substitutes and recourse obligations.

The agencies request comment on all aspects of this proposal.

B. Purpose and Effect

Implementation of all aspects of this proposal would result in more consistent treatment of recourse obligations and similar transactions among the agencies, more consistent risk-based capital treatment for transactions involving similar risk, and capital requirements that more closely reflect a banking organization's relative exposure to credit risk.

The agencies intend that any final rules adopted in connection with this proposal that result in increased risk-based capital requirements for banking organizations apply only to transactions that are consummated after the effective date of those final rules. The agencies intend that any final rules adopted in connection with this proposal that result in reduced risk-based capital requirements for banking organizations apply to all transactions outstanding as of the effective date of those final rules and to all subsequent transactions. Because some ongoing securitization conduits may need additional time to adapt to any new capital treatments, the agencies intend to permit asset securitizations with no fixed term, *e.g.*, asset-backed commercial paper conduits, to apply the existing capital rules for up to two years after the effective date of any final rule.

C. Background

1. Recourse and Direct Credit Substitutes

Asset securitization is the process by which loans and other receivables are pooled, reconstituted into one or more classes or positions, and then sold. Securitization provides an efficient mechanism for institutions to buy and sell loan assets and thereby to make them more liquid.

Securitizations typically carve up the risk of credit losses from the underlying assets and distribute it to different parties. The "first dollar" loss or subordinate position is first to absorb credit losses; the "senior" investor position is last; and there may be one or more loss positions in between ("second dollar" loss positions). Each loss position functions as a credit enhancement for the more senior loss positions in the structure.

For residential mortgages sold through certain Federally-sponsored mortgage programs, a Federal government agency or Federally-sponsored agency guarantees the securities sold to investors. However, many of today's asset securitization programs involve nonmortgage assets or are not supported in any way by the Federal government or a Federally-sponsored agency. Sellers of these privately securitized assets therefore often provide other forms of credit enhancement—first and second dollar loss positions—to reduce investors' risk of credit loss.

Sellers may provide this credit enhancement themselves through recourse arrangements. For purposes of this proposal, "recourse" refers to any risk of credit loss that an institution retains in connection with the transfer of its assets. While banking organizations have long provided recourse in connection with sales of whole loans or loan participations, recourse arrangements today are frequently associated with asset securitization programs.

Sellers may also arrange for a third party to provide credit enhancement in an asset securitization. If the third-party enhancement is provided by another banking organization, that organization assumes some portion of the assets' credit risk. For purposes of this proposal, all forms of third-party enhancements, *i.e.*, all arrangements in which an institution assumes risk of credit loss from third-party assets or other claims that it has not transferred, are referred to as "direct credit substitutes."[4] The economic substance of an institution's risk of credit loss from providing a direct credit substitute can be identical to its risk of credit loss from transferring an asset with recourse.

Depending on the type of securitization transaction, a portion of the total credit enhancement may also be provided internally, as part of the securitization structure, through the use of spread accounts, overcollateralization, or other forms of self-enhancement. Many asset securitizations use a combination of internal enhancement, recourse, and third-party enhancement to protect investors from risk of credit loss.

2. Prior History

On June 29, 1990, the Federal Financial Institutions Examination Council (FFIEC) published a request for comment on recourse arrangements. See

[1] The OTS is adding a definition of "standby-type letter of credit" to be consistent with the other agencies.

[2] See section II.C.3 of this preamble for a discussion of the distinction between "traded" and "non-traded" positions.

[3] "Nationally recognized statistical rating organization" means an entity recognized by the Division of Market Regulation of the Securities and Exchange Commission as a nationally recognized statistical rating organization for various purposes, including the capital rules for broker-dealers. See SEC Rule 15c3–1(c)(2)(vi)(E), (F) and (H) (17 CFR 240.15c3–1(c)(2)(vi)(E), (F), and (H).

[4] As used in this proposal, the terms "credit enhancement" and "enhancement" refer to both recourse arrangements and direct credit substitutes.

55 FR 26766 (June 29, 1990). The publication announced the agencies' intent to review the regulatory capital, reporting, and lending limit treatment of assets transferred with recourse and similar transactions, and set out a broad range of issues for public comment. The FFIEC received approximately 150 comment letters. The FFIEC then narrowed the scope of the review to the reporting and capital treatment of recourse arrangements and direct credit substitutes that expose banking organizations to credit-related risks. The OTS implemented some of the FFIEC's proposals (including the definition of recourse) on July 29, 1992 (57 FR 33432).

In July 1992, after receiving preliminary recommendations from an interagency staff working group, the FFIEC directed the working group to carry out a study of the likely impact of those recommendations on banking organizations, financial markets, and other affected parties. As part of that study, the working group held a series of meetings with representatives from 13 organizations active in the securitization and credit enhancement markets. Summaries of the information provided to the working group and a copy of the working group's letter sent to participants prior to the meetings are in the FFIEC's public file on recourse arrangements and are available for public inspection and photocopying. Additional material provided to the agencies from financial institutions and others since these meetings has also been placed in the FFIEC's public file. The FFIEC's offices are located at 2100 Pennsylvania Avenue, NW., Suite 200, Washington, DC 20037.

On May 25, 1994, the agencies published a **Federal Register** notice (1994 Notice) containing a proposal to reduce the capital requirement for banks for low-level recourse transactions (transactions in which the capital requirement would otherwise exceed an institution's maximum contractual exposure); to treat first-loss (but not second-loss) direct credit substitutes like recourse; and to implement definitions of "recourse," "direct credit substitute," and related terms. 59 FR 27116 (May 25, 1994). The 1994 Notice also contained, in an advance notice of proposed rulemaking, a proposal to use credit ratings to determine the capital treatment of certain recourse obligations and direct credit substitutes. The OCC, Board, and FDIC (the Banking Agencies) have since implemented the capital reduction for low-level recourse transactions required by section 350 of the Riegle Community Development and Regulatory Improvement Act, Public Law 103–325, 12 U.S.C. 4808. 60 FR 17986 (OCC, April 10, 1995), 60 FR 8177 (Board, February 13, 1995); 60 FR 15858 (FDIC, March 28, 1995). (The OTS risk-based capital regulation already included the low-level recourse treatment required by 12 U.S.C. 4808. See 60 FR 45618, August 31, 1995.) The other portions of the 1994 Notice will be addressed in this proposal.

The agencies have also implemented section 208 of the Riegle Community Development and Regulatory Improvement Act of 1994, Public Law 103–325, 108 Stat. 2160, 12 U.S.C. 1835, which made available an alternative risk-based capital treatment for qualifying transfers of small business obligations with recourse. 60 FR 45611(Board final rule, August 31, 1995); 60 FR 45605 (FDIC interim rule, August 31, 1995); 60 FR 45617 (OTS interim rule, August 31, 1995); 60 FR 47455 (OCC interim rule, September 13, 1995).

D. Current Risk-based Capital Treatment of Recourse and Direct Credit Substitutes

Currently, the agencies' risk-based capital standards apply different treatments to recourse arrangements and direct credit substitutes. As a result, capital requirements applicable to credit enhancements do not consistently reflect credit risk. The Banking Agencies' current rules are also not entirely consistent with those of the OTS.

1. Recourse

The agencies' risk-based capital guidelines prescribe a single treatment for assets transferred with recourse regardless of whether the transaction is reported as a financing or a sale of assets in a bank's Consolidated Reports of Condition and Income (Call Report). Assets transferred with any amount of recourse in a transaction reported as a financing remain on the balance sheet. Assets transferred with recourse in a transaction that is reported as a sale create off-balance sheet exposures. The entire outstanding amount of the assets sold (not just the amount of the recourse) is converted into an on-balance sheet credit equivalent amount using a 100% credit conversion factor, and this credit equivalent amount is risk-weighted.[5] In either case, risk-based capital is held against the full, risk-weighted amount of the transferred assets, subject to the low-level recourse rule which limits the maximum risk-based capital requirement to the bank's maximum contractual obligation.

For leverage capital ratio purposes, if a sale with recourse is reported as a financing, then the assets sold with recourse remain on the selling bank's balance sheet. If a sale with recourse is reported as a sale, the assets sold do not remain on the selling bank's balance sheet.

2. Direct Credit Substitutes

a. Banking Agencies. Direct credit substitutes are treated differently from recourse under the current risk-based capital standards. Under the Banking Agencies' standards, off-balance sheet direct credit substitutes, such as financial standby letters of credit provided for third-party assets, carry a 100% credit conversion factor. However, only the dollar amount of the direct credit substitute is converted into an on-balance sheet credit equivalent so that capital is held only against the face amount of the direct credit substitute. The capital requirement for a recourse arrangement, in contrast, is generally based on the full amount of the assets enhanced.

If a direct credit substitute covers less than 100% of the potential losses on the assets enhanced, the current capital treatment results in a lower capital charge for a direct credit substitute than for a comparable recourse arrangement. For example, if a direct credit substitute covers losses up to the first 20% of the assets enhanced, then the on-balance sheet credit equivalent amount equals that 20% amount and risk-based capital is held against only the 20% amount. In contrast, required capital for a first-loss 20% recourse arrangement is higher because capital is held against the full outstanding amount of the assets enhanced.

Banking organizations are taking advantage of this anomaly, for example, by providing first loss letters of credit to asset-backed commercial paper conduits that lend directly to corporate customers. This results in a significantly lower capital requirement than if the loans were on the banking organizations' balance sheets.

Under the proposal, the definition of direct credit substitute is expanded to include some items that already are partially reflected on the balance sheet, such as purchased subordinated interests. Currently, under the Banking Agencies' guidelines, these interests receive the same capital treatment as off-balance sheet direct credit substitutes. Purchased subordinated interests are placed in the appropriate risk-weight category. In contrast, if a banking organization retains a

[5] Current rules also provide for special treatment of sales of small business loan obligations with recourse. See 12 U.S.C. 1835.

subordinated interest in connection with the transfer of its own assets, this is considered recourse. As a result, the institution must hold capital against the carrying amount of the retained subordinated interest as well as the outstanding amount of all senior interests that it supports.

b. OTS.-The OTS risk-based capital regulation treats some forms of direct credit substitutes (*e.g.*, financial standby letters of credit) in the same manner as the Banking Agencies' guidelines. However, unlike the Banking Agencies, the OTS treats purchased subordinated interests under its general recourse provisions (except for certain high quality subordinated mortgage-related securities). The risk-based capital requirement is based on the carrying amount of the subordinated interest plus all senior interests, as though the thrift owned the full outstanding amount of the assets enhanced.

3. Problems With Existing Risk-based Capital Treatments of Recourse Arrangements and Direct Credit Substitutes.

The agencies are proposing changes to the risk-based capital standards to address the following major concerns with the current treatments of recourse and direct credit substitutes:

- Different amounts of capital can be required for recourse arrangements and direct credit substitutes that expose a banking organization to equivalent risk of credit loss.
- The capital treatment does not recognize differences in risk associated with different loss positions in asset securitizations.
- The current standards do not provide uniform definitions of recourse, direct credit substitute, and associated terms.

E. GAAP Accounting Treatment of Recourse Arrangements

The Banking Agencies' regulatory capital treatment of asset transfers with recourse differs from the accounting treatment of asset transfers with recourse under generally accepted accounting principles (GAAP). Under GAAP, an institution that transferred an asset with recourse before January 1, 1997, must reserve in a recourse liability account the probable expected losses under the recourse obligation and meet certain other criteria in order to treat the asset as sold. An institution that transfers an asset with recourse after December 31, 1996, must surrender control over the asset and receive consideration other than a beneficial interest in the transferred asset in order to treat the asset as sold. The institution must recognize a liability for its recourse obligation, measuring this liability at its fair value or by alternative means. Although the Banking Agencies have adopted GAAP for reporting sales of assets with recourse in 1997,[6] the agencies continue to require risk-based capital in addition to the GAAP recourse liability account for recourse obligations.

The agencies have considered the arguments that several commenters (responding to the 1994 Notice) made for adopting for regulatory capital purposes the GAAP treatment for all assets sold with recourse, including those sold with low levels of recourse. Under such a treatment, assets sold with recourse in accordance with GAAP would have no capital requirement, but the GAAP recourse liability account would provide some level of protection against losses.

One of the principal purposes of regulatory capital is to provide a cushion against unexpected losses. In contrast, the GAAP recourse liability account is, in effect, a specific reserve that primarily takes into account the probable expected losses under the recourse provision. The capital guidelines explicitly state that specific reserves may not be included in regulatory capital.

Even though a transferring institution may reduce its exposure to potential catastrophic losses by limiting the amount of recourse it provides, it may still retain, in many cases, the bulk of the credit risk inherent in the assets. For example, an institution transferring high quality assets with a reasonably estimated expected loss rate of one percent that retains ten percent recourse in the normal course of business will sustain the same amount of losses it would have had the assets not been transferred. This occurs because the amount of exposure under the recourse provision is very high relative to the amount of expected losses. In such transactions the transferor has not significantly reduced its risk for purposes of assessing regulatory capital and should continue to be assessed regulatory capital as though the assets had not been transferred.

Further, the agencies are concerned that an institution transferring assets with recourse might significantly underestimate its losses under the recourse provision or the fair value of its recourse obligation, in which case it would not establish an appropriate GAAP recourse liability account for the exposure. If the transferor recorded an inappropriately small liability in the GAAP recourse liability account for a succession of asset transfers, it could accumulate large amounts of credit risk that would be only partially reflected on the balance sheet.

For these reasons, the agencies have not proposed to adopt for regulatory capital purposes the GAAP treatment for assets sold with recourse. The agencies invite additional comments on this issue.

II. Notice of Proposed Rulemaking

This proposal would amend the agencies' risk-based capital standards as follows:

- Define recourse and revise the definition of direct credit substitute (See section II.A of this preamble);
- Treat recourse obligations and direct credit substitutes consistently for risk-based capital purposes (See section II.B of this preamble); and
- Vary the capital requirements for traded and non-traded positions in securitized asset transactions according to their relative risk exposure, using credit ratings from rating agencies to measure the level of risk (See sections II.C and II.D of this preamble).

Additionally, this notice discusses and requests comment on two possible alternatives to the use of credit ratings for non-traded positions in securitized transactions, either or both of which may be adopted, in whole or in part, in the final rule (See section II.E of this preamble). These alternatives would:

- Use criteria developed by the agencies, based on the criteria of the rating agencies, to determine the capital requirements; or
- Permit institutions to use historical loss information to determine the capital requirements for direct credit substitutes and recourse obligations.

A. Definitions

1. Recourse

The proposal defines recourse to mean any arrangement in which an institution retains risk of credit loss in connection with an asset transfer, if the risk of credit loss exceeds a *pro rata* share of the institution's claim on the assets. The proposed definition of recourse is consistent with the Banking Agencies' longstanding use of this term, and is intended to incorporate into the risk-based capital standards existing agency practices regarding retention of risk in asset transfers.[7]

[6] The OTS has followed GAAP since 1989 for reporting purposes and for computation of the capital leverage ratio.

[7] The OTS currently defines the term "recourse" more broadly than the proposal to include arrangements involving credit risk that a thrift

Continued

Currently, the term "recourse" is not explicitly defined in the Banking Agencies' risk-based capital guidelines. Instead, the guidelines use the term "sale of assets with recourse," which is defined by reference to the Call Report Instructions. *See* Call Report Instructions, Glossary (entry for "Sales of Assets"). Once a definition of recourse is adopted in the risk-based capital guidelines, the Banking Agencies would remove the cross-reference to the Call Report instructions from the guidelines. The OTS capital regulation currently provides a definition of the term "recourse," which would also be replaced once a final definition of recourse is adopted.

2. Direct Credit Substitute

The proposed definition of "direct credit substitute" is intended to mirror the definition of recourse. The term "direct credit substitute" would refer to any arrangement in which an institution assumes risk of credit-related losses from assets or other claims it has not transferred, if the risk of credit loss exceeds the institution's *pro rata* share of the assets or other claims. Currently, under the Banking Agencies' guidelines, this term covers guarantees and guarantee-type arrangements. As revised, it would also explicitly include items such as purchased subordinated interests, agreements to cover credit losses that arise from purchased loan servicing rights, and subordinated extensions of credit that provide credit enhancement.

3. Risks Other than Credit Risks

A capital charge would be assessed only against arrangements that create exposure to credit or credit-related risks. This continues the agencies' current practice and is consistent with the risk-based capital standards' traditional focus on credit risk. The agencies have undertaken other initiatives to ensure that the risk-based capital standards take interest rate risk and other non-credit related market risks into account.

4. Implicit Recourse

The definitions cover all arrangements that are recourse or direct credit substitutes in form or in substance. Recourse may also exist when an institution assumes risk of loss without an explicit contractual agreement or, if there is a contractual limit, when the institution assumes risk of loss in amounts exceeding the limit. The existence of implicit recourse is often a complex and fact-specific issue, usually demonstrated by an institution's actions beyond any contractual obligation. Actions that may constitute implicit recourse include: (a) Providing voluntary support for a securitization by selling assets to a trust at a discount from book value; (b) exchanging performing for non-performing assets; or (c) other actions that result in a significant transfer of value in response to deterioration in the credit quality of a securitized asset pool.

To date, the agencies have taken the position that when an institution provides implicit recourse, it should generally hold capital in the same manner as for assets sold with recourse. However, because of the complexity and fact-specific nature of many implicit recourse arrangements, questions have been raised as to how much risk the institution has effectively retained as a result of its actions and whether a different capital treatment would be warranted in some circumstances. To assist the agencies in assessing various types of implicit recourse arrangements, comment is requested on the following:

(*Question 1*) What types of actions should be considered implicit recourse, and how should the agencies treat these actions for regulatory capital purposes? Should the agencies establish different capital requirements for various types of implicit recourse arrangements? If so, how should appropriate capital requirements be determined for different types of implicit recourse arrangements? Please provide relevant data to support any recommended capital treatment.

The agencies may issue additional interpretive guidance as needed to further clarify the circumstances in which an institution will be considered to have provided implicit recourse.

One commenter responding to the 1994 Notice asked for clarification that a repurchase triggered by a breach of a standard representation or warranty (as defined below) would not be considered implicit recourse. Such a repurchase would not constitute implicit recourse because the repurchase is required by a contractual obligation created at the time of the sale.

5. Subordinated Interests in Loans or Pools of Loans

The definitions of recourse and direct credit substitute explicitly cover an institution's ownership of subordinated interests in loans or pools of loans. This continues the Banking Agencies' longstanding treatment of retained subordinated interests as recourse and recognizes that *purchased* subordinated interests can also function as credit enhancements. (The OTS currently treats both retained and purchased subordinated securities as recourse obligations.) Subordinated interests generally absorb more than their *pro rata* share of losses (principal or interest) from the underlying assets in the event of default. For example, a multi-class asset securitization may have several classes of subordinated securities, each of which provides credit enhancement for the more senior classes. Generally, the holder of any class that absorbs more than its *pro rata* share of losses from the total underlying assets is providing credit protection for all more senior classes.[8]

Two commenters questioned the treatment of purchased subordinated interests as recourse. Subordinated interests expose holders to comparable risk regardless of whether the interests are retained or purchased. If purchased subordinated interests were not treated as recourse, institutions could avoid recourse treatment by swapping retained subordinated interests with other institutions or by purchasing subordinated interests in assets originated by a conduit. The proposal would mitigate the effect of treating purchased subordinated interests as recourse by reducing the capital requirement on interests that qualify under the multi-level approach described in sections II.C, D, and E of this preamble.

6. *Second Mortgages*

Second mortgages or home equity loans would generally not be considered recourse or direct credit substitutes, unless they actually function as credit enhancements by facilitating the sale of the first mortgage. For example, this may occur if a lender has a program of originating first and second mortgages contemporaneously on the same property and then selling the first mortgage and retaining the second. In such a program, a second mortgage can function as a substitute for a recourse arrangement because it is intended that the holder of the second mortgage will absorb losses before the holder of the first mortgage does if the borrower fails to make all payments due on both loans.

The preamble to the 1994 Notice stated that a second mortgage originated

assumes or accepts from third-party assets as well as risk that it retains in an asset transfer. Under the proposal, as explained below, credit risk that an institution assumes from third-party assets would fall under the definition of "direct credit substitute" rather than "recourse."

[8] Current OTS risk-based capital guidelines exclude certain high-quality subordinated mortgage-related securities from treatment as recourse arrangements due to their credit quality. Consistent with these capital guidelines, the proposed OTS rule text includes the face value of high-quality subordinated mortgage-related securities in the 20% risk weight category.

contemporaneously with the first mortgage would be presumed to be recourse. Many commenters criticized this position as overly broad. The agencies agree and do not propose to retain the presumption.

However, the agencies expect institutions to follow prudent underwriting practices in making combined extensions of credit (*i.e.*, a contemporaneous first and second mortgage loan) or other second mortgages to a single borrower. If an institution does not apply prudent underwriting standards in making combined loans, the agencies will consider this practice in determining whether the institution is using such mortgages to retain recourse and generally in evaluating the soundness of the institution's underwriting standards and in determining the adequacy of the institution's capital.

7. Representations and Warranties

When a banking organization transfers assets, including servicing rights, it customarily makes representations and warranties concerning those assets. When a banking organization purchases loan servicing rights, it may also assume representations and warranties made by the seller or a prior servicer. These representations and warranties give certain rights to other parties and impose obligations upon the seller or servicer of the assets. The definitions in this proposal would treat as recourse or direct credit substitutes any representations or warranties that create exposure to default risk or any other form of open-ended, credit-related risk from the assets that is not controllable by the seller or servicer. This reflects the agencies' current practice with respect to recourse arising out of representations and warranties, and explicitly recognizes that a servicer with purchased loan servicing rights can also take on risk through servicer representations and warranties.

The agencies recognize, however, that the market requires asset transferors and servicers to make certain representations and warranties, and that most of these present only normal operational risk. Currently, the agencies have no formal definitions distinguishing between these types of standard representations and warranties and those that create recourse or direct credit substitutes. The proposal therefore defines the term "standard representations and warranties" and provides that seller or servicer representations or warranties that meet this definition are not considered to be recourse obligations or direct credit substitutes.

Under the proposal, "standard representations and warranties" are those that refer to an existing state of facts that the seller or servicer can either control or verify with reasonable due diligence at the time the assets are sold or the servicing rights are transferred. These representations and warranties will not be considered recourse or direct credit substitutes, provided that the seller or servicer performs due diligence prior to the transfer of the assets or servicing rights to ensure that it has a reasonable basis for making the representation or warranty. The term "standard representations and warranties" also covers contractual provisions that permit the return of transferred assets in the event of fraud or documentation deficiencies, (*i.e.*, if the assets are not what the seller represented them to be), consistent with the current Call Report Instructions governing the reporting of asset transfers. After a final definition of "standard representations and warranties" is adopted for the risk-based capital standards, the Banking Agencies would recommend to the FFIEC that the Call Report Instructions be changed to conform to the capital guidelines and the OTS would similarly amend the instructions for the Thrift Financial Report (TFR).

Examples of "standard representations and warranties" include seller representations that the transferred assets are current (*i.e.*, not past due) at the time of sale; that the assets meet specific, agreed-upon credit standards at the time of sale; or that the assets are free and clear of any liens (provided that the seller has exercised due diligence to verify these facts). An example of a nonstandard representation and warranty is an agreement by the seller to buy back any assets that become more than 30 days past due or default within a designated time period after the sale. Another example of a nonstandard representation and warranty is a representation that all properties underlying a pool of transferred mortgages are free of environmental hazards. This representation is not verifiable by the seller or servicer with reasonable due diligence because it is not possible to absolutely verify that a property is, in fact, free of all environmental hazards. Such an open-ended guarantee against the risk that unknown but currently existing hazards might be discovered in the future would be considered recourse or a direct credit substitute. However, a seller's representation that all properties underlying a pool of transferred mortgages have undergone environmental studies and that the studies revealed no known environmental hazards would be a "standard representation and warranty" (assuming that the seller performed the requisite due diligence). This is a verifiable statement of facts that would not be considered recourse or a direct credit substitute.

Some commenters responding to the 1994 Notice supported this proposed definition. Many commenters addressing the definition opposed it. Commenters objected to the definition for the following reasons: treating representations and warranties as recourse would place banks at a competitive disadvantage with other institutions; representations and warranties are not equivalent to recourse because the risk involved may be considerably less than the risk of borrower default; and representations and warranties that relate to operational risk should not be recourse because recourse is supposed to address only credit risks. Some commenters suggested the agencies replace the due diligence requirement with a "not known to be false" standard.

The agencies have decided to retain the proposed definition of standard representations and warranties for purposes of this proposal. Where a representation or warranty functions as recourse, failure to recognize the recourse obligation and to require appropriate capital would create a loophole that would defeat the purposes of the proposal.

The definitions of "recourse," "direct credit substitute," and "standard representations and warranties" are intended to treat as recourse or a direct credit substitute only those representations or warranties that create exposure to default risk or any other form of open-ended, credit-related risk from the assets that is not controllable by the seller or servicer. The agencies wish to clarify that only those representations and warranties that expose an institution to credit risk (as opposed to interest rate risk) will be classified as recourse or direct credit substitutes.

The proposal would treat as recourse a representation or warranty that functions as recourse but that is guaranteed by a third party. The agencies request comment on whether the recourse rules should place assets subject to a representation or warranty that constitutes recourse in the 20 percent risk weight category if a third party guarantees the representation or warranty and has unsecured debt that is rated in the highest rating category.

8. Loan Servicing Arrangements

The proposed definitions of "recourse" and "direct credit substitute" cover loan servicing arrangements if the servicer is responsible for credit losses associated with the loans being serviced. However, cash advances made by residential mortgage servicers to ensure an uninterrupted flow of payments to investors or the timely collection of the mortgage loans are specifically excluded from the definitions of recourse and direct credit substitute, provided that the residential mortgage servicer is entitled to reimbursement for any significant advances.[9] Such advances are assessed risk-based capital only against the amount of the cash advance, and are assigned to the risk-weight category appropriate to the party obligated to reimburse the servicer.

If the residential mortgage servicer is not entitled to full reimbursement, then the maximum possible amount of any nonreimbursed advances on any one loan must be contractually limited to an insignificant amount of the outstanding principal on that loan in order for the obligation to make cash advances to be excluded from the definitions of recourse and direct credit substitute. This treatment reflects the agencies' traditional view that servicer cash advances meeting these criteria are part of the normal mortgage servicing function and do not constitute credit enhancements.

Commenters generally supported the proposed definition of servicer cash advances. Some commenters asked for clarification of the terms "insignificant" and whether "reimbursement" includes reimbursement payable out of subsequent collections or reimbursement in the form of a general claim on the party obligated to reimburse the servicer. Nonreimbursed advances contractually limited to no more than one percent of the amount of the outstanding principal would be considered insignificant. Reimbursement includes reimbursement payable from subsequent collections and reimbursement in the form of a general claim on the party obligated to reimburse the servicer, provided that the claim is not subordinated to other claims on the cash flows from the underlying asset pool.

[9] Servicer cash advances include disbursements made to cover foreclosure costs or other expenses arising from a loan in order to facilitate its timely collection (but not to protect investors from incurring these expenses).

9. Spread Accounts and Overcollateralization

Several commenters requested that the agencies state in their rules that spread accounts and overcollateralization do not impose a risk of loss on an institution and are not recourse. By its terms, the definition of recourse covers only the retention of risk in a sale of assets. Neither a spread account (unless reflected on an institution's balance sheet) nor overcollateralization ordinarily impose a risk of loss on an institution, so neither would fall within the proposed definition of recourse. However, a spread account reflected as an asset on an institution's balance sheet would be a form of recourse or direct credit substitute and would be treated accordingly for risk-based capital purposes.

B. Treatment of Direct Credit Substitutes

The agencies are proposing to extend the current risk-based capital treatment of asset transfers with recourse, including the low-level recourse rule, to direct credit substitutes. As previously explained, the current risk-based capital assessment for a direct credit substitute such as a standby letter of credit may be dramatically lower than the assessment for a recourse provision that creates an identical exposure to risk. As noted previously, the OTS capital rule already treats most direct credit substitutes (other than financial standby letters of credit) in the same manner as recourse obligations.

Currently, an institution that sells assets with 10 percent recourse must hold capital against the full amount of the assets transferred. On the other hand, an institution that extends a letter of credit covering the first 10 percent of losses on the same pool of assets must hold capital against only the face amount of the letter of credit. Banking organizations are taking advantage of this anomaly by providing first loss letters of credit to asset-backed commercial paper conduits that lend directly to corporate customers, which results in a significantly lower capital requirement than if the loans had been on the organizations' balance sheets and were sold with recourse.

In the 1994 Notice, the agencies proposed to change only the treatment of direct credit substitutes that absorb the first dollars of losses from the assets enhanced. The agencies proposed to delay changing the treatment of other direct credit substitutes until a multi-level approach could be implemented. Some commenters suggested that the agencies adopt a comprehensive approach, implementing a change in the treatment of direct credit substitutes only in the context of a multi-level approach, and observed that a piecemeal approach would be unduly disruptive. The agencies agree and now propose to implement the change in the treatment of direct credit substitutes in combination with the multi-level approach. As proposed, the multi-level approach applies to direct credit substitutes and recourse obligations related to asset securitizations. The agencies request comment on how the final rule could prudently and effectively apply the multi-level approach to direct credit substitutes and recourse obligations not related to asset securitizations.

Several commenters objected to the proposed treatment of direct credit substitutes as recourse. Commenters objected that the proposed capital treatment would impair the competitive position of U.S. banks and thrifts and that the business of providing third-party credit enhancements has historically been safe and profitable for banks. Notwithstanding these concerns, the agencies believe that the current treatment of direct credit substitutes is not consistent with the treatment of recourse obligations, and that the difference in treatment between the two forms of credit enhancement invites institutions to convert recourse obligations into direct credit substitutes in order to avoid the capital requirement applicable to recourse obligations and balance-sheet assets. The agencies request comment on the proposed treatment of direct credit substitutes and on the effect of the proposed treatment on the competitive position of U.S. banks.

The Banking Agencies have raised the issue of increasing the capital requirement for direct credit substitutes and lowering the capital requirement for highly-rated senior securities with the bank supervisory authorities from the other countries represented on a subgroup of the Basle Committee on Banking Supervision in an effort to eliminate competitive inequities.

C. Multi-level Ratings-based Approach

Many asset securitizations carve up the risk of credit losses from the underlying assets and distribute it to different parties. A credit enhancement (that is, a recourse arrangement or direct credit substitute) that has no prior loss protection is a "first dollar" loss position. There may be one or more layers of additional credit enhancement after the first dollar loss position. Each loss position functions as a credit enhancement for the more senior loss positions in the structure. Currently, the risk-based capital standards do not vary the rate of capital assessment with differences in credit risk represented by different credit enhancement or loss positions.

To address this issue, the agencies are proposing a "multi-level" approach to assessing capital requirements on recourse obligations, direct credit substitutes, and senior securities in asset-securitizations based on their relative exposure to credit risk. The agencies are proposing a ratings-based approach that would use credit ratings from the rating agencies to measure relative exposure to credit risk and to determine the associated risk-based capital requirement. The use of credit ratings would provide a way for the agencies to use market determinations of credit quality to identify different loss positions for capital purposes in an asset securitization structure. This may permit the agencies to give more equitable treatment to a wide variety of transactions and structures in administering the risk-based capital system.

Under the ratings-based approach, the capital requirement for a recourse obligation, direct credit substitute, or senior security would be determined as follows: [10]

- A position rated in the highest investment grade rating category would receive a 20 percent risk weight.
- A position rated investment grade but not in the highest rating category would receive one of two alternative treatments the agencies are considering: (1) The "face value" option would apply a 100 percent risk weight to the book value or face amount of the position; or (2) the "modified gross-up" option would apply a 50 percent risk weight to the amount of the position plus all more senior positions. (Section II.D of this preamble discusses and provides examples of these two alternatives.)
- Recourse obligations and direct credit substitutes not qualifying for a reduced capital charge and positions rated below investment grade would receive "gross-up" treatment—the institution holding the position would hold capital against the amount of the position plus all more senior positions, subject to the low-level recourse rule. [11]

If a recourse obligation, direct credit substitute, or senior security receives different ratings from the rating agencies, the highest ratings would determine the capital treatment. For traded positions, the single highest rating would apply. For positions that require two ratings (*see* section II.C.3 of this preamble), the lower of the two highest ratings would apply.

1. 1994 Notice

The 1994 Notice described, in an advance notice of proposed rulemaking, a ratings-based approach under which investment grade positions rated in the highest rating category would receive a 20 percent risk weight and other investment grade positions would receive a 100 percent risk weight. Some commenters responding to the 1994 Notice supported the ratings-based approach described in that notice as a flexible, efficient, market-oriented way to measure risk in securitizations. Many commenters also noted that a ratings-based approach was not a perfect or complete solution, especially for non-traded positions that would otherwise not need to be rated. The agencies recognize additional options for non-traded positions could be useful in conjunction with or in lieu of the ratings-based approach and are considering other approaches, which are described in section II.E of this preamble.

In the 1994 Notice the agencies suggested that a ratings-based, multi-level approach should be restricted to transactions involving the securitization of large, diversified asset pools in which all forms of first dollar loss credit enhancement are either completely free of third-party performance risk or are provided internally as part of the securitization structure. Additionally, the agencies had suggested that the ratings-based approach be available only for positions other than first-loss positions. Many commenters pointed out that credit ratings incorporate this information and that the threshold criteria were redundant. The agencies agree and have not included these criteria in the proposal.

2. Effect of Ratings Downgrades

The ratings-based approach would be based on current ratings, so that a rating downgrade or withdrawal of a rating could change the treatment of a position under the proposal. However, a downgrade by a single rating agency rating would not affect the capital treatment of a position if the position still qualified for the treatment under another rating from a different rating agency.

3. Non-traded Positions

In response to the 1994 Notice, one rating agency expressed concern that regulatory use of ratings could undermine the integrity of the rating process.[12] Ordinarily, according to the commenter, there is a tension between the interests of the investors who rely on ratings and the interests of the issuers who pay rating agencies to generate ratings. Under the ratings-based approach, the holder of a recourse obligation or direct credit substitute that is not traded or sold may, in some cases, ask for a rating just to qualify for a favorable risk weight. The rating agency expressed a strong concern that, without the counterbalancing interest of investors who will be relying on the rating, rating agencies may have an incentive to issue inflated ratings.

In response to this concern, the agencies have developed proposed criteria to reduce the possibility of inflated ratings and inappropriate risk weights if ratings are used for a position that is not traded. The agencies are proposing that such a position could qualify for the ratings-based approach if: (1) It qualifies under ratings from two different rating agencies; (2) the ratings are publicly available; (3) the ratings are based on the same criteria used to rate securities sold to the public; and (4) at least one position in the securitization is traded.

For purposes of this proposal a position is considered "traded" if, at the time it is rated, there is a reasonable expectation that in the near future: (1) The position may be sold to investors relying on the rating or (2) a third party may enter into a transaction such as a loan or repurchase agreement involving the position in which the third party relies on the rating of the position.

In Section II.E of this preamble, the agencies describe two alternative approaches to the ratings-based approach for non-traded securitization positions: the "ratings benchmark" approach and the "historical loss" approach. The agencies may decide to adopt either or both of these approaches, or portions of them, to either replace or supplement the ratings-

[10] In this preamble, "AAA" refers to the highest investment-grade rating, and "AA", "A", and "BBB" refer to other investment-grade ratings. These rating designations are illustrative and do not indicate any preference or endorsement of any particular rating agency designation system.

[11] Under the "gross-up" treatment, a position is combined with all more senior positions in the transaction. The result is then risk-weighted based on the nature of the underlying assets. For example, if an institution retains a first-loss position in a pool of mortgage loans that qualify for a 50 percent risk weight, the institution would include the full amount of the assets in the pool, risk-weighted at 50 percent, in its risk-weighted assets for purposes of determining its risk-based capital ratio. The "low level" recourse rule limits the capital requirement for recourse obligations to the institution's maximum contractual obligation. 12 U.S.C. 4808.

[12] See T. McGuire, Moody's Investors Service, Ratings in Regulation: A Petition to the Gorillas (1995).

based approach for non-traded positions.

(*Question 2*) How could the agencies prudently and effectively apply the multi-level approach to direct credit substitutes and recourse obligations not related to asset securitizations?

(*Question 3*) What would be the most appropriate oversight mechanism for verifying ratings on nontraded positions? For instance, should an institution be required to obtain a detailed explanation from the rating agency of the basis for the rating on the non-traded position? Should the institution be required to make this substantiating information available to the regulatory agencies for review purposes?

(*Question 4*) How can the agencies determine if a rating on a non-traded position is inappropriately high? Does any available evidence show that regulatory rules based on ratings for traded positions have led to inappropriately high ratings?

(*Question 5*). For a rated position to be considered traded, an institution must have a reasonable expectation when the position is rated that a sale or other transaction involving the position will take place in the near future. The agencies request comment on this definition and on the time period that is appropriate to use for defining the "near future."

D. Face Value and Modified Gross-up Alternatives for Investment Grade Positions Below the Highest Investment Grade Rating

1. Description of Approaches

The agencies are seeking comment on two alternative approaches for calculating the capital requirement for investment grade positions rated below the highest investment grade level (*i.e.*, AAA).[13] One alternative, the "face value" approach, would apply a 100 percent risk weight to the book value or face amount of all investment grade positions below the highest investment grade level, regardless of their position within a securitization structure. The other alternative, the "modified gross-up" approach, would gross-up all investment grade positions below the highest investment grade level and then apply a 50 percent risk weight to the grossed-up amount. For senior investment grade positions below the highest investment grade level, this approach would have the effect of applying a 50 percent risk weight to these positions.[14] The agencies seek comment on which of these two alternative approaches should be adopted or on possible alternatives to the two described here.

a. Rationale for the Modified Gross-Up Proposal.—The modified gross-up approach is being proposed because of a concern that junior positions that represent only a small portion of a securitization (so-called "thin-strip" mezzanine positions) may qualify for an investment grade rating despite a concentration of risk on the position that makes them substantially more risky than investment grade whole securities with the same underlying collateral. Some rating agencies do not take into account the severity of loss posed by this risk concentration when rating these mezzanine positions. Other rating agencies do so in a way that may be insufficient for risk-based capital purposes. (*See* detailed explanations in subsections b and c).

An underlying premise of the modified gross-up approach is that an investment grade thin-strip mezzanine piece likely poses more risk of a larger percentage loss than a similarly rated whole asset-backed security. This additional risk is related to the variability of losses on the mezzanine position.[15]

Additionally, there is some evidence that investors account for the additional concentration of credit risk in thin-strip mezzanine positions by demanding higher yields for these positions. This is especially the case for ratings that do not account for severity of loss on the mezzanine position.

The modified gross-up capital treatment is designed to account for the fact that a thin-strip mezzanine position and whole security with the same credit ratings have similar credit risks and should, therefore, have similar dollar capital requirements. Relative to the "face value" treatment, it would more fully account for the concentration risk in these positions as it relates to the current risk-based capital framework.

The modified gross-up proposal would gross-up mezzanine positions to take into account any additional credit risk concentration that may not be fully captured by the ratings. However, if such positions are rated investment grade, but are below the highest investment grade level, this proposal would place their grossed-up amounts in the 50 percent risk weight category. In addition, senior investment grade positions below the highest investment grade level would be placed in the 50 percent risk weight category. The 50 percent risk weight was selected because it lies between the agencies' proposed 20 percent risk weight for the highest investment grade level and the 100 percent risk weight that applies to most positions below investment grade that would be fully grossed-up in this proposed rule.

b. Concerns with Ratings Based on Probability of Default. The agencies understand that certain rating agencies base their ratings on the probability that the position will experience any losses, regardless of the severity of loss on the position. These types of ratings will be referred to as "probability of default" ratings.

If a rating for a security is based solely on the probability of default (*i.e.*, the probability of any losses), both a whole asset-backed security and a junior security carved out of that whole security will receive exactly the same rating. Both securities have the same probability of default. Since the junior piece is smaller than the whole security, any losses on the security's underlying loan pool will create a larger loss as a percentage of the junior piece (*i.e.*, a higher loss severity) than the percentage loss on the larger whole security.

Consider the following: Assume that $1,050 in commercial loans are used to create a $1,000 whole security, Security 1, and a $50 credit enhancement supporting Security 1. The $1,000 security receives the lowest investment grade rating (BBB), based on the $50 credit enhancement (the C piece). The $1,000 security is subsequently divided into two pieces, a $900 senior piece, Security 2A (the A piece), and a $100 junior piece, Security 2B (the B piece, which is the mezzanine position between the A and C pieces). The senior piece receives a AAA rating because its probability of default has decreased. The junior piece, on its own, will still receive a BBB rating because its

[13] The option that is chosen would be applicable to the ratings benchmark and historical loss approaches discussed later in this preamble.

[14] If a subordinated position receives the highest investment grade rating, it would not be grossed up under the modified gross-up approach. This is due to the relatively low risk implied by the rating.

[15] The variability of loss can be characterized by its variance, which measures the distribution of potential losses around the expected loss. The larger the variance, the more likely that the actual outcome will be further away from the expected loss. For example, consider two securities with the same expected loss. The first security has two possible loss scenarios, $7 and $13, that each have a probability of 50 percent. The expected loss on this security is $10, but its variance is 9 and its standard deviation is 3. A second security has two possible loss scenarios, $0 and $20, that also have probabilities of 50 percent. The expected loss on this security is also $10, but its variance is 100 and its standard deviation is 10. The variances and standard deviations for the two securities are very different. From a capital adequacy standpoint, the second security poses a greater risk of loss than the first security. Hence, the second security should have a larger capital cushion, even though the expected loss on both positions is the same.

probability of default is the same as the $1,000 whole security prior to dividing the whole security into two pieces. The percentage impact of any unexpected losses on the junior piece, though, can be many times greater than that on the whole security because any losses on the underlying pool of loans will be absorbed by the smaller principal amount of the junior security. (*See* Figure 1.)

Assume that most of the risk of credit loss for the $1,050 pool of commercial loans described previously is concentrated in the bottom $150 portion of the loans. The credit enhancement (the C piece) would absorb the first $50 of losses. The $100 junior piece (*i.e.*, Security 2B, the mezzanine position) would, therefore, contain the balance of the credit risk of the $1,000 whole security. Since most of the credit risk of the $1,000 whole security is concentrated in this junior piece, for capital adequacy purposes, the appropriate dollar capital charge on the $100 junior piece and the $1,000 security should, in theory, be approximately the same. This would produce an equal capital buffer for positions with approximately equal credit risk. On a percentage basis, applying the same dollar capital charge against this mezzanine position and the whole security results in a ten-times higher percentage requirement on the mezzanine position than the "face value" option because its face value is one-tenth the size of the whole security ($100 versus $1,000).

c. Concerns with Ratings Based on Expected Losses. The agencies understand that some ratings are provided based on expected losses (*i.e.*, the sum of all the possible losses weighted by the probabilities of their occurrence) rather than just the probability of default. This approach takes into account both the severity and likelihood of losses, and therefore addresses some of the problems presented by the probability of default approach. Rating agencies that use the expected loss approach require a small increase in the credit enhancement (the C piece) supporting the junior piece (Security 2B) in order for this piece to obtain the same credit rating as the whole security (Security 1). While this additional credit enhancement is required to account for the concentration of credit risk in the junior piece, for risk-based capital purposes, the enhancement may not fully compensate for this concentration risk. (Figure 2)

d. Concerns About Modified Gross-up Proposal. There is some concern that the additional capital that the modified gross-up approach requires for certain situations may be disproportionate to the extent to which ratings, in fact, fail to capture the concentration of risk in mezzanine positions. In particular, for multi-tier securitizations that have several investment grade tiers below the highest investment grade rating, the modified gross-up approach may require too much capital when all tiers are held in the banking system because each tier would be grossed up and placed in the 50 percent risk weight category. Example 4 illustrates this concern.

(Question 6). The agencies request comments comparing the face value treatment with the modified gross-up treatment, and on other refinements the agencies could consider to address their concerns regarding the capital charge that would apply to thin-strip mezzanine positions under the ratings-based approach.

(Question 7). For the modified gross-up approach, the agencies have some concern that a 50 percent risk-weighting may be inappropriate to apply to the grossed-up positions of securitizations. If this is the case, what should the alternative risk weight be for the grossed-up security and what data are available to support this alternative risk weight?

(Question 8). For a thin-strip mezzanine position, a rating agency that uses the expected losses approach requires a higher credit enhancement to obtain a specified rating than a rating agency that uses the probability of loss approach because the former takes into account the loss severity of the position. Should the agencies have different capital standards based on which of the two approaches is used for determining the rating for the position?

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Figure 1 -- Probability of Loss Approach

(Security 1 and Security 2B are Rated BBB, Security 2A is Rated AAA)

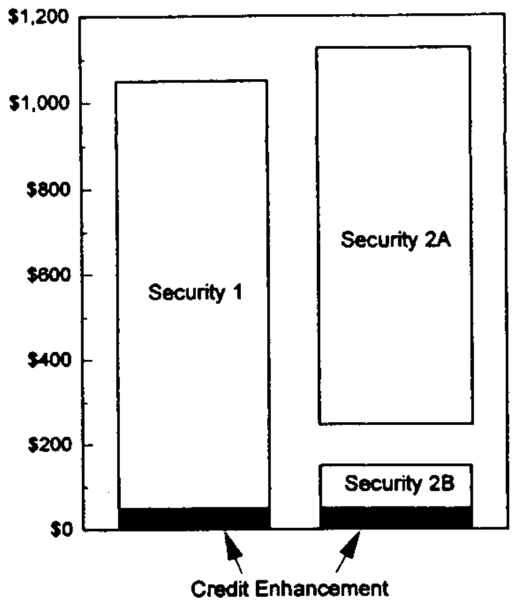
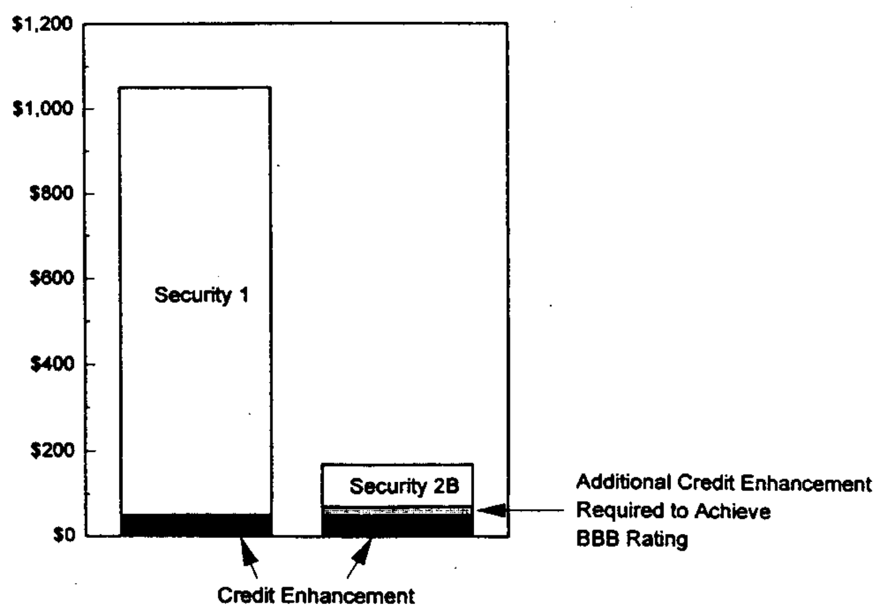


Figure 2 -- Expected Value Approach

(Security 1 and Security 2B are Rated BBB)



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2. Examples of Face Value and Modified Gross-up Approaches

The capital requirements under the modified gross-up approach would differ substantially from a face-value treatment. The modified gross-up approach results in a higher capital requirement for thin-strip BBB-rated mezzanine positions than the face value approach. On the other hand, for senior BBB-rated positions, the modified gross-up approach results in a lower capital requirement than the face value approach.

For instance, based on the example cited previously, the modified gross-up approach for the $100 BBB-rated mezzanine position (Security 2B) would produce a capital charge of $40 (the grossed-up amount which is equal to Security 2A plus Security 2B, $1,000, times 50 percent times 8 percent) while the face value approach would produce a capital requirement of $8 (the face amount of Security 2B, $100, times 100 percent times 8 percent). For the $1,000 senior BBB-rated position (Security 1, the whole security), the modified gross-up approach would produce a capital requirement of $40 ($1,000 times 50 percent times 8 percent) while the face value approach would produce a capital requirement of $80 ($1,000 times 100 percent times 8 percent).

The four following examples illustrate, for various types of securitization structures, the capital requirements for thrifts and banks under current rules and under the proposed face value and modified gross-up alternatives.

Example 1

Bank A issues three classes of securities that are backed by a $100 million pool of loans. These classes include a bottom-level (first-loss) subordinated class of $11 million, a publicly-traded middle-level subordinated class of $9 million, and a publicly-traded senior class of $80 million. Bank A retains the bottom-level class and sells the other two classes to other banks or thrifts.

Under the face value and modified gross-up approaches, Bank A, retaining the bottom-level subordinated class, would be required to hold risk-based capital equal to 8 percent of the $100 million pool or $8 million (the full effective risk-based capital requirement for the outstanding amount of the assets enhanced). Assume that because the subordinated class provides sufficient first dollar loss enhancement, a nationally recognized statistical rating organization gives the $9 million publicly-traded middle class the lowest investment grade rating. Under the face value approach, the capital requirement for an institution holding the position would be 8 percent of $9 million or $720 thousand. Under the modified gross-up approach the capital requirement is 4 percent (50 percent times 8 percent) of the grossed-up amount of $89 million ($9 million plus $80 million) or $3.56 million. Finally, assume that the $80 million senior class receives the highest credit rating, which qualifies it for a 20 percent risk weight under both approaches. The capital requirement for an institution holding this piece would be 1.6 percent (20 percent times 8 percent) of $80 million or $1.28 million. Table 1 summarizes this example.

TABLE 1.—A–B–C STRUCTURE

[Underlying Assets—$100 million of Non-Mortgage Loans]

Position	Size ($ mil)	Credit rating	Current capital requirement for thrifts ($ mil)	Current capital requirement for banks ($ mil)	Face value approach ($ mil)	Modified gross-up approach ($ mil)
A	$80	AAA	$6.40	$6.40	$1.28	$1.28
B	9	BBB	7.12	0.72	0.72	3.56
C	11	Unrated	8.00	8.00	8.00	8.00
Total Capital			21.52	15.12	10.00	12.84

Example 2

Bank A issues two classes of securities that are backed by a $100 million pool of loans. These classes include a bottom-level (first-loss) subordinated class of $20 million and a publicly-traded senior class of $80 million. Bank A retains the bottom-level class and sells the senior class to other banks or thrifts.

Under both the face value and the modified gross-up approaches, Bank A, retaining the bottom-level subordinated class, would be required to hold risk-based capital equal to 8 percent of the $100 million pool or $8 million (the full effective risk-based capital requirement for the outstanding amount of the assets enhanced). Assume that because the subordinated class provides sufficient first dollar loss enhancement, a nationally recognized statistical rating organization gives the $80 million publicly-traded senior class an A rating. Under the face value approach, the capital requirement for an institution holding position would be 8 percent of $80 million or $6.4 million. Under the modified gross-up approach, the capital requirement is 4 percent (50 percent times 8 percent) of the grossed-up amount of $80 million (which, in this case, is the senior piece) or $3.2 million. Table 2 summarizes this example.

TABLE 2.—A–B STRUCTURE

[Underlying Assets—$100 million of Non-Mortgage Loans]

Position	Size ($ mil)	Credit rating	Current capital requirement for thrifts ($ mil)	Current capital requirement for banks ($ mil)	Face value approach ($ mil)	Modified gross-up approach ($ mil)
A	$80	A	$6.40	$6.40	$6.40	$3.20
B	20	Unrated	8.00	8.00	8.00	8.00
Total Capital			14.40	14.40	14.40	11.20

Example 3

Bank A issues four classes of securities that are backed by a $100 million pool of mortgage loans. These classes include a bottom-level (first-loss) subordinated class of $0.75 million (the D position), two thin publicly-traded middle-level subordinated classes (the B and C positions, $1.5 and $0.75 million, respectively), and a senior class of $97 million which meets the requirements for a SMMEA security. Bank A retains the bottom-level class and sells the other three classes to banks or thrifts. (Under current rules, the Banking Agencies apply a 100 percent risk weight to the B and C positions, even though the underlying assets have a 50 percent risk weight, because the B and C positions are subordinated.)

Under both the face value and the modified gross-up approaches, Bank A, retaining the bottom-level subordinated class, would be required to hold risk-based capital equal to 4 percent of the $100 million pool, limited to its $0.75 million maximum exposure (low-level recourse). Assume that because the subordinated class provides sufficient prior credit enhancement to the classes above it, a nationally recognized statistical rating organization gives the two publicly-traded middle classes ratings of BBB and A and the senior class a rating of AAA. The capital requirements for the various tranches are as follows. The current treatment for banks holding the $97 million AAA-rated senior mortgage position is to apply a 50 percent risk weight to the position resulting in a capital requirement of $3.88 million ($97 million times 50 percent times 8 percent). The current treatment for thrifts holding this $97 million position is to apply a 20 percent risk weight to the position resulting in a capital requirement of $1.552 million ($97 million times 20 percent times 8 percent). Under both the face value and modified gross-up approaches, the 20 percent risk weight would apply to the $97 million position. For the two investment grade positions below AAA (the B and C positions), the current thrift rules require full gross-up of the positions and the resulting capital requirement is subject to the low-level recourse rule that limits the requirement to the size of the position. The modified gross-up approach results in a capital requirement exceeding the size of the position and would also be subject to the low-level rule. The current bank rules, which use the face value approach, would apply a 100 percent risk weight to the position. Table 3 summarizes this example.

TABLE 3—MULTI-TRANCHE STRUCTURE

[Underlying Assets—$100 million of 50 percent Risk-Weight Mortgage Loans]

Position	Size ($ mil)	Credit rating	Current capital requirement for thrifts ($ mil)	Current capital requirement for banks ($ mil)	Face value approach ($ mil)	Modified gross-up approach ($ mil)
A	$97.0	AAA	$1.552	$3.880	$1.552	$1.552
B	1.5	A	1.500	0.120	0.120	1.500
C	0.75	BBB	0.750	0.060	0.060	0.750
D	10.75	Unrated	0.750	0.750	0.750	0.750
Total Capital			4.552	4.810	2.482	4.552

Example 4

A bank issues seven classes of securities (A through G) backed by a $100 million pool of loans and retains a junior $6 million subordinated interest. Additional credit enhancement available to the class G securities enables those securities to obtain an A rating. The other positions are rated as indicated in Table 4.

TABLE 4—MULTI-TRANCHE STRUCTURE

[Underlying Assets—$100 million of Non-Mortgage Loans]

Position	Size ($ mil)	Credit rating	Current capital requirement for thrifts ($ mil)	Current capital requirement for banks ($ mil)	Face value approach ($ mil)	Modified-gross-up approach ($ mil)
A	$32	AAA	$2.56	$2.56	0.51	0.51
B	21	AAA	4.24	1.68	0.34	0.34
C	17	AAA	5.60	1.36	0.27	0.27
D	6	AA	6.00	0.48	0.48	3.04
E	6	A	6.00	0.48	0.48	3.28
F	6	BBB	6.00	0.48	0.48	3.52
G	6	A	6.00	0.48	0.48	3.76
Retained	6	Unrated	6.00	6.00	6.00	6.00
Total Capital			42.40	13.52	9.04	20.72

E. Alternative Approaches

1. Ratings Benchmark Approach

a. Description of Approach. Because of some concerns with the use of the ratings-based approach for non-traded positions, the agencies are considering another alternative—the ratings benchmark approach. Under this alternative, the agencies would issue benchmark guidelines that would be used in assessing the relative credit risk of non-traded positions in specified standardized securitization structures. The ratings benchmarks would set credit enhancement requirements and other pool standards for such securitizations. If a non-traded position in such a securitization fulfills the applicable standards, and the securitization structure includes at least one traded position, the non-traded position will be eligible for the same capital treatment as investment-grade positions under the ratings-based approach.

The agencies are considering this approach: (1) To recognize and build on consensus in the market regarding the amount of prior credit enhancement and pool standards necessary to obtain an "A" rating from the rating agencies; (2) To reduce the cost and regulatory burden of requiring institutions to obtain ratings on non-traded positions in such securitizations; and (3) To ensure that the agencies retain supervisory discretion to supplement the rating agencies' standards by adding criteria that the agencies consider essential to protect the safe operation of insured institutions.

b. Development and Application of Ratings Benchmarks. The credit enhancement requirements and other pool standards for each type of securitization would be based on information available from the rating agencies regarding the relative credit risk of various types of asset pools. The ratings benchmark for each type of pool would be based on the rating agencies' requirements for credit enhancement and other pool standards necessary for the assignment of an "A" rating. Relying on the "A" rating standard provides assurance of a level of credit quality and permits the use of a relatively simple benchmark, while ensuring that the noninvestment-grade positions are not given preferential capital treatment.

The agencies would limit the application of the ratings benchmark approach to positions in a securitization structure in which there is at least one traded position. This limitation is intended to ensure that the pool standards imposed on securitizations by the rating agency selected to rate the traded position would provide an extra measure of protection reinforcing the agencies' benchmark standards.

To be eligible for the capital treatment under the ratings benchmark approach, the benchmarks would require a specified amount of prior credit enhancement based on the type of asset securitization involved. Recourse arrangements and direct credit substitutes that fail to satisfy the applicable benchmarks would be grossed-up.[16]

Under the ratings benchmark approach, qualifying prior credit enhancements include: cash collateral accounts,[17] subordinated interests or classes of securities; spread accounts,[18] including those funded initially with a loan repaid from excess cash flow; and other forms of overcollateralization involving excess cash flows (e.g., placing excess receivables into the pool so that total cash flows expected to be received exceed cash flows required to pay investors). These forms of credit enhancement are consistent with the proposal contained in the 1994 Notice which defined prior credit enhancement for the purposes of applying the multi-level ratings based approach.

Consistent with comments received on the 1994 Notice and the types of credit enhancement generally relied on by the ratings agencies in rating asset pools, the agencies would also permit forms of prior credit enhancement involving third-party performance risk. Specifically, the agencies would permit: pool insurance, financial guarantees, and standby letters of credit issued or guaranteed by companies rated or whose debt is rated, in the highest two investment categories by two rating agencies or similar rating organizations. Third party credit enhancements would qualify under the ratings benchmark approach if: (1) the credit enhancement absorbs credit losses before an institution's non-traded position absorbs losses; and (2) the credit enhancement represents an unconditional obligation of the third party providing the enhancement.

c. Computation of Capital Requirements under the Ratings Benchmark Approach. Non-traded positions in asset securitizations meeting the benchmark standards would receive the same capital treatment as investment grade positions under the ratings-based approach (*i.e.*, either the face value treatment or the modified gross-up treatment). Eligible positions would not be subject to the full gross-up treatment.

If the agencies have not developed a ratings benchmark for a specific type of transaction, or if a position in a securitization structure does not qualify under an established benchmark, the non-traded position will be subject to the full gross-up approach, unless it otherwise qualifies for the multi-level treatment under some other approach for non-traded positions ultimately adopted in this rulemaking.

d. Publication of Benchmarks. Initial benchmarks are provided for securitizations backed by residential mortgages, credit cards, auto loans, trade receivables, and commercial real estate. The prior credit enhancement requirements and other pool standards contained in these initial benchmarks have been based on discussions with rating agencies and public information submitted to the agencies in this rulemaking.[19] Public comment is solicited on all aspects of the ratings benchmark approach, including the standards contained in the benchmarks.

If the ratings benchmark approach is adopted, the agencies would update the benchmarks at least once every two years based on a survey of rating agencies. The revisions to the benchmarks for each asset type would be based on the average of the two highest enhancement requirements of the rating agencies responding to a survey.

Additionally, if this approach is adopted, the agencies would establish new benchmarks for additional types of securitizations based on continuing discussions with insured institutions and rating agencies regarding appropriate pool standards and market developments. New benchmarks would be issued only for types of securitizations for which the agencies believe there is a market consensus on: (1) The amount of prior credit enhancement; and (2) the pool standards that such securitization positions generally must satisfy to obtain the equivalent of an "A" rating from rating agencies.

The biennial changes to established benchmarks and the addition of new benchmarks would be published for notice and comment in the **Federal Register**. The publication would indicate the amount of credit enhancement required for the type of securitization, and set forth other pool standards and restrictions. After considering any comments, the agencies would publish the revised benchmarks in the **Federal Register**.

e. Implementation. The agencies may adopt all or part of this approach without reproposal, as modified based on comments, in the final rule issued in this rulemaking. In addition, if the agencies adopt this approach in the final rule, they may initially implement the approach on a smaller scale. For example, the approach may initially be limited to use with securitizations backed by residential mortgages, credit card or trade receivables. Non-traded positions in other types of securitizations would either have to qualify for some other approach adopted in the final rule or be subject to the full gross-up approach.

f. Benchmarks. Following are draft initial ratings benchmarks for securitizations backed by residential mortgages, credit cards, automobile loans, trade receivables, and commercial real estate.

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[16] If a non-traded position failed to comply with any revised benchmark standards for the specific asset type, the position would be subject to the gross-up approach.

[17] A cash collateral account is a separate account funded with a loan from the provider of the credit enhancement. Funds in the account are available to cover potential losses.

[18] A spread account is typically a trust or special account that the issuer establishes to retain interest rate payments in excess of the sum of the amounts due investors from the underlying assets, plus a normal servicing fee rate. The excess spread serves as a cushion to cover potential losses on the underlying loans.

[19] See Duff and Phelps Credit Rating Company Presentation to Federal Financial Institutions Examinations Council (April 18, 1995). This document is available for public review in the FFIEC public reference room at 2100 Pennsylvania Avenue, NW., Suite 200 Washington, DC. The benchmarks in this document, however, do not purport to reflect the current standards of that company or any specific rating agency.

RESIDENTIAL MORTGAGE-BACKED SECURITIES

Pool Type [1, 2]	"Rating Benchmark" prior credit enhancement required for "A" rating	Pool standards
30-year loans	1.6 percent	Pools include at least 400 loans for each pool type.
15-year loans	0.8 percent	
Adjustable Rate Mortgages (ARMs) (1,5), (2,6).	2.4 percent	No borrower concentration over 3 percent for each pool type.
Hybrid loans (fixed-to-variable).	2.4 percent	
Balloon loans	2.0 percent For no documentation and reduced documentation loans, multiply the above enhancements by 2. For condominiums, two-to-four family, and cooperative apartments, multiply the above enhancements by 2. For B and C loans, multiply the above enhancements by 3. For loan-to-value (LTV) ratios equal to or below 80 percent: —Use above enhancements. —Multiply above enhancements by 2, if there is purchase mortgage insurance (PMI) that brings loans below 80 percent. For LTV ratios above 80 percent, multiply the above enhancements by 4. For the first five years of the securitization, the above enhancement requirement, as a percentage of the outstanding principal, remains fixed. For years six through ten, the enhancement requirement would be multiplied by 0.75. Beyond ten years, the enhancement would be multiplied by 0.5[3, 4].	

[1] For positions that represent less than 10 percent of the size of the underlying pool of loans, add 20 percent to the enhancement level.
[2] For closed-end second mortgage securities, determine the LTV ratio of the loans in the security and apply the enhancement requirements for the underlying collateral. In addition, change the 15-year enhancement requirement to 1.6 percent due to increased risk of security.
[3] The reduction in the multiplier over time reflects the reduced risk of the mortgage portfolio due to seasoning.
[4] For a six-year old 15-year mortgage-backed security backed by B and C loans that have LTV ratios above 80 percent, the enhancement would be 0.8 percent x 3 x 4 x 0.75 = 7.2 percent.

ASSET-BACKED SECURITIES

Pool Type [1]	"Rating Benchmark" prior credit enhancement required for "A" rating	Pool standards
Credit cards [2]	The higher of 6 percent or 1.2 times lagged charge-off rate [3]	Enhancement has access to excess spread.
Auto Loans:.		
Prime (A type)	7.0 percent	Sellers of automobile loans must have at least three years of historical information.
Sub-prime (B, C, and D types).	The higher of 15.0 percent or 3 times net expected loss rate [4]	Enhancement has access to excess spread.
Trade Receivables	12.0 percent per loan pool [5] (if all sellers of trade receivables are rated 1 or 2) 18.0 percent per loan pool [5] (if any seller of trade receivables is rated 3 or 4 and no lower than 4).	Pools may not have seller concentrations above 5 percent of pool amount.
		Based on Federal Reserve Board rating criteria for trade receivables, each seller must be rated between 1 and 4.
	The above enhancements will remain fixed as a percentage of outstanding principal, with a floor of 3 percent of original principal.	For credit cards and auto loans, pool must be randomly selected and nationally-diversified.

[1] For positions that represent less than 10 percent of the size of the underlying pool of loans, add 20 percent to the credit enhancement level.
[2] Credit cards include home equity lines of credit that are similar to credit card loans.
[3] Lagged charge-off rate is based on the monthly average of past six month's charge-offs, multiplied by twelve, then divided by the average outstanding balance from a year ago.
[4] Net expected loss rate is the monthly average of last quarter's gross default amount netted against recoveries, multiplied by twelve, then divided by the average outstanding loan balance for the last quarter.
[5] Overcollateralization amount would count toward credit enhancement.

COMMERCIAL MORTGAGE-BACKED SECURITIES

Pool type [1]	"Rating Benchmark" prior credit enhancement required for "A" rating	Pool standards
Office	26.0 percent	Debt-service coverage at least 1.25

COMMERCIAL MORTGAGE-BACKED SECURITIES—Continued

Pool type [1]	"Rating Benchmark" prior credit enhancement required for "A" rating	Pool standards
Regional Mall	10.0 percent	Debt-service coverage at least 1.35
Industrial/Anchored Retail	13.0 percent	Debt-service coverage at least 1.35
Multifamily	17.0 percent	Debt-service coverage at least 1.25
	The above enhancements are for pools of loans with loan-to-value ratios less than or equal to 70 percent. For pools of loans with greater than 70 percent loan-to-value ratio, multiply the above enhancements by 1.5.	For each type of pool above: —No borrower concentration over 5 percent of pool amount. —The amortization schedule does not exceed 25 years.
	For pools with property quality below the B level, multiply the above enhancements by 1.5.	
	The above enhancements will remain fixed as a percentage of outstanding principal, with a floor of 3 percent of original principal [2]..	

[1] For positions that represent less than 10 percent of the underlying pool of loans, add 20 percent to the credit enhancement level.
[2] For example, the enhancement for a security containing regional mall loans with an 80 percent LTV ratio and B quality property would be 10 percent x 1.5 x 1.5 = 22.5 percent.

g. Examples. To determine the dollar amount of prior credit enhancement required for a non-traded position of a securitization, the percentages shown in the benchmarks would be applied to the outstanding amount of the underlying loans in the securitization and monitored regularly by the regulatory agencies and by institutions. For example, for residential mortgage loans, the credit enhancement for a non-traded securitization position must be maintained at the outstanding principal level multiplied by 100 percent of the benchmark level for years one through five. For years six through ten, the required enhancement would be set at 75 percent of the benchmark level. For years eleven and beyond the enhancement requirement would be set at 50 percent of the benchmark level.[20]

Example of a Residential Mortgage Securitization. Assume an institution has provided a 3 percent guarantee on a $6 million mezzanine position of a $200 million residential mortgage securitization. The junior position is a $10 million piece held by a second institution. The underlying mortgages are 15-year fixed-rate "B" and "C" residential mortgage loans with no greater than 70 percent loan-to-value ratios (LTV), with no private mortgage insurance. The benchmark requirement would be 0.8 percent (15-year mortgages) times 1 (70 percent LTV ratio) times 3 ("B" and "C" loans) or 2.4 percent of the securitization amount of $200 million, which equals $4.8 million. Since the $10 million junior position exceeds $4.8 million, the guarantee would not be subject to the gross-up approach.

After one year, losses on the pool are $2 million and the size of the pool decreases to $190 million. The benchmark requirement would be 2.4 percent of $190 million or $4.5 million. Since the junior piece of $8 million still exceeds $4.5 million, the guarantee would still not be subject to the gross-up approach.

Example of a Credit Card Securitization. Assume an institution has provided a guarantee for the bottom 15 percent of a $100 million credit card securitization. This bottom position is unrated. A third party provides a cash collateral account of 7 percent or $7 million in front of the unrated position. Because the pool is new, the institution must project the annual loss experience on the pool.[21] In this case, it projects 4 percent. Based on the benchmarks, the 4 percent should be multiplied by 1.2 and then compared with 6 percent to determine which of the two numbers is higher. Since 6 percent is higher, the benchmark requirement becomes 6 percent of $100 million or $6 million. Since the cash collateral account of $7 million exceeds 6 percent of $100 million, the guarantee would receive a risk weight that is lower than under the gross-up approach.

After one year, the pool of credit card loans decreases to $80 million. The experience on these credit card loans indicates that the lagged loss rate of the loans is 7 percent of the pool, not 4 percent as projected. In addition, assume the cash collateral account provided by the third party decreases to $5 million net of excess cash flows and pool losses. The benchmark is the higher of 6 percent or 8.4 percent (1.2 times 7 percent). The 8.4 percent benchmark is applied to the $80 million pool resulting in a required enhancement of $6.7 million. Since this exceeds the $5 million cash collateral account, the gross-up approach would be applied to the guarantee. To avoid the fully-grossed-up treatment, the third party would need to increase the cash collateral account by $1.7 million to $6.7 million.

Example of a Trade Receivable Securitization. Assume an institution has provided a guarantee on the bottom 12 percent portion of an asset-backed commercial paper program. All of the seller programs within the structure are rated 1 or 2 by the regulator. No program within the structure represents more than 5 percent of the pool and each program within the pool has 15 percent overcollateralization. The guarantee on this commercial paper program would not be grossed up because it is well-diversified, all programs are rated 1 or 2, and the over-collateralization exceeds 12 percent.

Assume that after six months, two of the pool's overcollateralization levels decrease to 10 percent and one of the seller programs is rated 3. The guarantee would be subject to the gross-up

[20] The reduction in the required credit enhancement amount over time is due to the reduced credit risk of seasoned mortgage loan pools.

[21] If the institution has experience with this type of pool, then this historical experience should be used to determine the loss rate required to determine the benchmark.

approach for either of two reasons. First, none of the seller programs have 18 percent collateral, which is the new requirement based on the one program that is rated 3. Second, even if the one program was not rated 3, the two programs with 10 percent collateral do not meet the 12 percent collateral requirement for 1- and 2-rated seller programs.

(*Question 9*) What changes, if any, should be made to the amounts of prior credit enhancement and the pool standards required by the agencies' benchmarks? Please provide supporting information, if available.

(*Question 10*) Can the benchmark standards be simplified without unduly relaxing the protection afforded to institutions by these standards?

(*Question 11*) What additional types of pools and securitization transactions are sufficiently standardized and homogenous to permit the agencies to develop reliable benchmarks? Would it be reasonable to handle these securitizations on a case-by-case basis using the best available data from the rating agencies at the time of the securitization?

(*Question 12*) Is the biennial review and update of the benchmarks appropriate?

(*Question 13*) Please comment on ways the agencies could most effectively evaluate and monitor institutions' use of ratings benchmarks in the examination process with the least possible burden on institutions and examiners.

(*Question 14*) Should the agencies adopt both the ratings-based approach and ratings benchmark approach for non-traded positions? Alternatively, should the agencies adopt only one of these approaches for non-traded positions in rated securitizations?

(*Question 15*) If the agencies decide to adopt both approaches, should institutions be given the discretion to elect which of these approaches to use for their non-traded positions? On the other hand, if the agencies adopt the ratings benchmark approach, should the ratings-based approach be used for non-traded positions in securitizations for which a benchmark has not been developed?

(*Question 16*) Please compare the relative financial and operational burdens that would be imposed on institutions by the ratings-based approach and ratings benchmark approach for non-traded positions.

2. Internal Information Approaches

In response to the 1994 Notice, the agencies also received several comments proposing approaches under which an institution would use credit information it has about the underlying assets to set the capital requirement for a position. These commenters observed that evaluating credit risks is a traditional area of bank expertise and that an institution knows its own assets better than anyone else.

The agencies agree that using the information that institutions have about the credit quality of assets underlying a position could, if feasible, be more efficient than any of the ratings-based approaches for assessing capital requirements on non-traded positions. Therefore, the agencies are considering two approaches based on this type of information: the "historical loss" approach and the "bank model" approach. The agencies may adopt all or part of this historical loss approach in the final rule adopted in this rulemaking without reproposal. Accordingly, the agencies solicit comments and supporting information to aid in their development of the historical loss and bank model approaches.

a. Historical Loss Approach. A principal purpose of regulatory capital is to provide a cushion against unexpected losses. The historical loss approach being considered by the agencies would take unexpected losses over the life of the asset pool into account. These losses may not be taken into account fully in the ratings-based approaches. The historical loss approach, however, bases the risk-based capital treatment for a position in a securitization on the characteristics of the underlying pool of assets, including the variance of losses. This variance is the source of unexpected losses. While the historical loss approach could, in theory, be used for all recourse obligations and direct credit substitutes, the agencies are proposing that the approach initially be applied only to non-traded positions in securitizations with at least one traded position.

To measure the variance of losses on a pool of assets, an institution would have to project the probability distribution of the cumulative losses on the underlying assets over the life of the pool based on historical loss information for assets comparable to those in the pool. Comparability would encompass such factors as credit quality, collateral, and repayment terms. The cumulative losses would be the portion of the assets in the pool that would not be recovered over the life of the pool.

Under this approach, the risk-based capital treatment for a non-traded position would depend on the expected value of losses on the underlying pool, plus a specified number of standard deviations. As a general rule, at the inception of a securitization, the holder or issuer of a non-traded position would determine whether the holder would incur a loss if the cumulative losses on the underlying assets in the pool reached the expected value of losses plus the designated number of standard deviations (e.g., expected loss plus five standard deviations for normal distributions). This determination would consider any available qualifying credit enhancements providing support to the position and the existence of any more junior positions in the securitization.

Thus, the expected value of losses plus the designated number of standard deviations would serve as a boundary. If the holder of a non-traded position would suffer a loss when the level of cumulative losses on the underlying assets in the pool reached this boundary, then the position would receive the gross-up treatment. The institution's capital requirement, however, would be subject to the low-level rule. Otherwise, the position would qualify to be treated in the same manner as traded positions with ratings below "AAA" under the multi-level, ratings-based approach. In short, the non-traded position would qualify to use either the face value treatment or the "modified gross-up" approach, depending upon which of these proposed alternatives the agencies adopt in their final rules (*see* sections II.C and II.D of this preamble). An institution's estimate of the probability distribution, measurement of the variance, assessment of the support provided by credit enhancements, and determination of the loss exposure on a non-traded position, as well as the resulting risk-based capital treatment of the position, would be subject to review by examiners.

In projecting the probability distribution of the losses on a pool's underlying assets, an institution would need to compile and analyze historical loss information for individual assets that are comparable to those in the pool. This would include considering the size of the losses on individual assets and, depending on the type of credit enhancement supporting the securitization, the amount of time after the origination of the type of assets being securitized when losses generally occur on that asset type. This information may be available from the information the issuer supplies to the rating agencies for their use in rating the securitization's traded positions.

The agencies are proposing that the types of credit enhancement that would qualify to be considered when determining whether the holder of a non-traded position would incur any losses be the same as those proposed under the ratings benchmark approach. The size or availability of one or more of the credit enhancements in a securitization (e.g., a spread account), however, may vary over time based on the performance of the pool's underlying assets. If such a credit enhancement supports one or more of the positions in a securitization, the institution also would need to consider the shape of the loss curve over the life of the pool that produces cumulative losses over that period equal to the expected value of losses, plus the designated number of standard deviations. In this situation, as a supplement to the general rule cited previously, the size of the credit enhancement that would be available at any point over the life of the pool given the loss curve's indicated level of losses would need to be sufficient to prevent the holder of a non-traded position from suffering a loss in order for the non-traded position to avoid application of the gross-up approach.

As an example of the application of this historical loss approach, assume an institution owns a non-traded $100 subordinated piece of a $1,000 securitized asset pool. A qualifying standby letter of credit issued by a bank will absorb the first $20 of losses for the pool, thereby providing partial protection to the institution's subordinated position. For asset pools of this type, the institution determines that the expected value of losses plus the designated number of standard deviations over the life of the pool is $80. Given the size of the credit enhancement, the institution will sustain a loss of $60 on its subordinated interest if pool losses reach the expected value of losses, plus the designated number of standard deviations. Therefore, the institution's position would be subject to the gross-up approach. Capital would be held for the institution's position plus all more senior positions. After considering the $20 qualifying standby letter of credit (which would be treated as a bank guarantee on part of the pool) and assuming the assets in the pool are risk-weighted at 100 percent, the risk-based capital charge for the subordinated piece would be $78.72 [($20 x 20 percent x 8 percent) + ($980 x 100 percent x 8 percent)].

In contrast, if the expected value of losses plus the designated number of standard deviations over the life of the pool in the preceding example were only $19, the $20 credit enhancement would fully absorb those losses and the institution would not expect to incur any losses on its subordinated position. The institution's position would qualify for the capital treatment applicable to traded investment-grade positions rated below "AAA."

Based on discussions with market participants, the agencies believe that those institutions that are active in the securitization business will normally possess historical loss data for assets comparable to those they are securitizing. In this regard, these institutions must be capable of measuring and monitoring the credit risk they have retained or assumed in securitizations to conduct their securitization activities in a safe and sound manner. If an institution were unable to do the statistical analysis necessary to implement this proposed historical loss approach, however, its non-traded positions would be subject to the gross-up approach.

(Question 17) Given the varying number of years in the life of a pool for different types of assets, what is the minimum number of years of historical loss data that should be used to project the probability distribution of the cumulative losses on each type of underlying asset pool over the pool's life? If information for the minimum number of years is not available, is it reasonable for institutions to be required to apply the gross-up approach to non-traded positions?

(Question 18) How should institutions determine whether the capital requirement for a non-traded position should be changed over time? Should institutions periodically adjust the loss distribution that they used to set their initial capital requirement to reflect actual losses on pool assets over the life of the pool?

(Question 19) Is it reasonable for the agencies to use a log normal curve to describe the distribution of losses on a pool of assets? Would another approach be preferable and, if so, why would it be preferable?

(Question 20) Would this approach be applicable to all asset types or are there some asset types with unusual characteristics for which this approach would be inappropriate?

(Question 21) How burdensome would this historical loss approach be for institutions? To what extent is the necessary loss data available? What modifications should the agencies consider making as they develop this approach?

b. *Bank Model Approach.* Commenters on the 1994 Notice suggested that the capital requirements for recourse obligations and direct credit substitutes also could be based on internal risk assessments made by banks holding those positions. Over the past decade, some banking organizations have developed, for their own internal risk management purposes, statistical techniques for quantifying the credit risk in sub-portfolios of credit instruments such as direct credit substitutes. In principle, these "internal models" for measuring credit risk could be used in setting capital requirements for direct credit substitutes and possibly other credit positions. Such a system would be broadly consistent with both the internal models approach to capital now being implemented for market risks associated with bank trading activities, as well as with current supervisory policies for evaluating the adequacy of the allowance for loan and lease losses.

Currently, the agencies are uncertain whether an internal model approach is feasible. However, the agencies recognize that the development of an internal model approach to capital for direct credit substitutes, and perhaps for other credit instruments, could have significant benefits. For example, under the ratings approach, a bank's internal risk assessment—if acceptable to supervisors—might substitute for a credit rating, thus reducing costs and delays associated with obtaining credit ratings. Alternatively, an acceptable internal model for measuring credit risk might form the basis for assessing capital requirements on a portfolio basis rather than on an asset-by-asset basis, thus better reflecting a bank's diversification and hedging activities.

The agencies note that securitization activities can create positions that add significantly to the volatility, appropriately measured, of an institution's credit losses. Banks for which such activities are significant should have in place appropriate policies and practices to quantify and manage the credit risk associated with securitization. The agencies, as always, will review the quality of such policies and practices within the context of evaluating the overall quality of a bank's risk management processes.

(Question 22) Is an internal model approach to setting capital requirements for recourse, direct credit substitutes, and other credit instruments currently feasible and, if so, how might it be structured?

(Question 23) Which types of credit activities would be amenable to such an approach?

(Question 24) How could the agencies validate such internal models and their credit risk assessments?

III. Regulatory Flexibility Act

OCC: Pursuant to section 605(b) of the Regulatory Flexibility Act, the OCC certifies that this proposal will not have a significant impact on a substantial number of small entities. 5 U.S.C. 601 *et seq.* The provisions of this proposal that increase capital requirements are likely to affect large banks almost exclusively. (Small banks are unlikely to be in a position to provide direct credit substitutes in asset securitizations.) Accordingly, a regulatory flexibility analysis is not required.

Board: Pursuant to section 605(b) of the Regulatory Flexibility Act, the Board does not believe this proposal will have a significant impact on a substantial number of small business entities in accord with the spirit and purposes of the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*). The Board's comparison of the applicability section of this proposal with Call Report Data on all existing banks shows that application of the rule to small entities will be the rare exception. Accordingly, a regulatory flexibility analysis is not required. In addition, because the risk-based capital standards generally do not apply to bank holding companies with consolidated assets of less than $150 million, this rule will not affect such companies.

FDIC: Pursuant to section 605(b) of the Regulatory Flexibility Act (Pub. L. 96–354, 5 U.S.C. 601 *et seq.*), the FDIC certifies that the proposed rule will not have a significant impact on a substantial number of small entities. Comparison of Call Report data on FDIC-supervised banks to the items covered by the proposal that result in increased capital requirements shows that application of the rule to small entities will be the infrequent exception.

OTS: Pursuant to section 605(b) of the Regulatory Flexibility Act, the OTS certifies that this proposal will not have a significant impact on a substantial number of small entities. The proposal is likely to reduce slightly the risk-based capital requirements for recourse obligations and direct credit substitutes, except for some standby letters of credit. Thrifts currently issue few, if any, standby letters of credit. Accordingly, a regulatory flexibility analysis is not required.

IV. Paperwork Reduction Act

Board: In accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. Ch. 3506; 5 CFR 1320 Appendix A.1), the Board reviewed the proposed rule under the authority delegated to the Board by the Office of Management and Budget. No collections of information pursuant to the Paperwork Reduction Act are contained in the proposed rule.

V. Executive Order 12866

OCC: On the basis of the best information available, the OCC has determined that this proposal is not a significant regulatory action for purposes of Executive Order 12866. However, the impact of any final rule resulting from this proposal will depend on factors for which the agencies do not currently collect industry-wide information, such as the proportion of bank-provided direct credit substitutes that would be rated below investment grade. The OCC therefore welcomes any quantitative information national banks wish to provide about the impact they expect the various portions of this proposal to have if issued in final form.

OTS: The Director of the OTS has determined that this proposal does not constitute a "significant regulatory action" under Executive Order 12866. The proposal is likely to reduce slightly the risk-based capital requirements for recourse obligations and direct credit substitutes, except for some standby letters of credit. Thrifts currently issue few, if any, standby letters of credit. As a result, the OTS has concluded that the proposal will have only minor effects on the thrift industry.

VI. OCC and OTS—Unfunded Mandates Reform Act of 1995

Section 202 of the Unfunded Mandates Reform Act of 1995 (Unfunded Mandates Act), requires that an agency prepare a budgetary impact statement before promulgating a rule that includes a Federal mandate that may result in the expenditure by state, local, and tribal governments, in the aggregate, or by the private sector, of $100 million or more in any one year. If a budgetary impact statement is required, section 205 of the Unfunded Mandates Act also requires an agency to identify and consider a reasonable number of regulatory alternatives before promulgating a rule. The OCC and OTS have determined that this proposal will not result in expenditures by state, local, and tribal governments, or by the private sector, of more than $100 million or more in any one year. Therefore, the OCC and OTS have not prepared a budgetary impact statement or specifically addressed the regulatory alternatives considered. As discussed in the preamble, this proposal rule will correct certain inconsistencies in the agencies' risk-based capital standards and will allow banking organizations to maintain lower amounts of capital against certain rated recourse obligations and direct credit substitutes.

List of Subjects

12 CFR Part 3

Administrative practice and procedure, Capital, National banks, Reporting and recordkeeping requirements, Risk.

12 CFR Part 208

Accounting, Agriculture, Banks, banking, Confidential business information, Crime, Currency, Federal Reserve System, Mortgages, Reporting and recordkeeping requirements, Securities.

12 CFR Part 225

Administrative practice and procedure, Banks, banking, Federal Reserve System, Holding companies, Reporting and recordkeeping requirements, Securities.

12 CFR Part 325

Administrative practice and procedure, Banks, banking, Capital adequacy, Reporting and recordkeeping requirements, Savings associations, State non-member banks.

12 CFR Part 567

Capital, Reporting and recordkeeping requirements, Savings associations.

Office of the Comptroller of the Currency

12 CFR Chapter I

Authority and Issuance

For the reasons set out in the preamble, appendix A of part 3 of chapter I of title 12 of the Code of Federal Regulations is proposed to be amended as follows:

PART 3—MINIMUM CAPITAL RATIOS; ISSUANCE OF DIRECTIVES

1. The authority citation for part 3 continues to read as follows:

Authority: 12 U.S.C. 93a, 161, 1818, 1828(n), 1828 note, 1831n note, 1835, 3907 and 3909.

2. In part 3, appendix A, section 3, paragraph (b) is amended by adding a new sentence at the end of the introductory text; paragraph (b)(1)(i) and footnote 13 are removed and reserved; paragraph (b)(1)(ii) is revised; paragraph (b)(1)(iii) and footnote 14 are removed and reserved; footnote 16 in paragraph (b)(2)(i) and footnote 17 in paragraph (b)(2)(ii) are revised; and paragraph (d) is revised to read as follows:

Appendix A to Part 3—Risk-Based Capital Guidelines

* * * * *

Section 3. Risk Categories/Weights for On-Balance Sheet Assets and Off-Balance Sheet Items

* * * * *

(b) * * * However, direct credit substitutes, recourse obligations, and securities issued in connection with asset securitizations are treated as described in section 3(d) of this appendix A.

(1) * * *

(ii) Risk participations purchased in bankers' acceptances.

* * * * *

(2) * * *

(i) * * * [16] * * *

(ii) * * * [17] * * *

* * * * *

(d) *Recourse obligations, direct credit substitutes, and asset- and mortgage-backed securities.* (1) *Definitions.* For purposes of this section 3 of this appendix A:

(i) *Direct credit substitute* means an arrangement in which a national bank assumes, in form or in substance, any risk of credit loss directly or indirectly associated with a third-party asset or other financial claim, that exceeds the national bank's *pro rata* share of the asset or claim. If a national bank has no claim on the asset, then the assumption of any risk of credit loss is a direct credit substitute. Direct credit substitutes include, but are not limited to:

(A) Financial guarantee-type standby letters of credit that support financial claims on the account party;

(B) Guarantees, surety arrangements, and irrevocable guarantee-type instruments backing financial claims;

(C) Purchased subordinated interests or securities that absorb more than their *pro rata* share of losses from the underlying assets;

(D) Loans or lines of credit that provide credit enhancement for the financial obligations of an account party; and

(E) Purchased loan servicing assets if the servicer is responsible for credit losses associated with the loans being serviced (other than servicer cash advances as defined in section 3(d)(1)(v) of this appendix A), or if the servicer makes or assumes representations and warranties on the loans (other than standard representations and warranties as defined in section 3(d)(1)(vi) of this appendix A).

(ii) *Financial guarantee-type standby letter of credit* means any letter of credit or similar arrangement, however named or described, which represents an irrevocable obligation to the beneficiary on the part of the issuer:

(A) To repay money borrowed by, or advanced to, or for the account of, an account party; or

(B) To make payment on account of any indebtedness undertaken by an account party, in the event that the account party fails to fulfill its obligation to the beneficiary.

(iii) *Rated* means, with respect to an instrument or obligation, that the instrument or obligation has received a credit rating from a nationally-recognized statistical rating organization. An instrument or obligation is rated investment grade if it has received a credit rating that falls within one of the four highest rating categories used by the nationally-recognized statistical rating organization. An instrument or obligation is rated in the highest investment grade category if it has received a credit rating that falls within the highest investment grade category used by the nationally-recognized statistical rating organization.

(iv) *Recourse* means the retention in form or substance of any risk of credit loss directly or indirectly associated with a transferred asset that exceeds a *pro rata* share of a national bank's claim on the asset. If a national bank has no claim on a transferred asset, then the retention of any risk of credit loss is recourse. A recourse obligation typically arises when an institution transfers assets and retains an obligation to repurchase the assets or to absorb losses due to a default of principal or interest or any other deficiency in the performance of the underlying obligor or some other party. Recourse may exist implicitly where a bank provides credit enhancement beyond any contractual obligation to support assets it has sold. Recourse obligations include, but are not limited to:

(A) Representations and warranties on the transferred assets (other than standard representations and warranties as defined in section 3(d)(1)(vi) of this appendix A);

(B) Retained loan servicing assets if the servicer is responsible for losses associated with the loans serviced (other than a servicer cash advance as defined in section 3(d)(1)(v) of this appendix A);

(C) Retained subordinated interests or securities that absorb more than their *pro rata* share of losses from the underlying assets;

(D) Assets sold under an agreement to repurchase; and

(E) Loan strips sold without direct recourse where the maturity of the transferred loan is shorter than the maturity of the commitment.

(v) *Servicer cash advance* means funds that a residential mortgage loan servicer advances to ensure an uninterrupted flow of payments or the timely collection of residential mortgage loans, including disbursements made to cover foreclosure costs or other expenses arising from a mortgage loan to facilitate its timely collection. A servicer cash advance is not a recourse obligation or a direct credit substitute if:

(A) The mortgage servicer is entitled to full reimbursement; or

(B) For any one mortgage loan, nonreimbursable advances are contractually limited to an insignificant amount of the outstanding principal on that loan.

(vi) *Standard representations and warranties* means contractual provisions that a national bank extends when it transfers assets (including loan servicing assets), or assumes when it purchases loan servicing assets. To qualify as a standard representation or warranty, a contractual provision must:

(A) Refer to facts that the seller or servicer can verify, and has verified with reasonable due diligence, prior to the time that assets are transferred (or servicing assets are acquired);

(B) Refer to a condition that is within the control of the seller or servicer; or

(C) Provide for the return of assets in the event of fraud or documentation deficiencies.

(vii) *Traded position* means a recourse obligation, direct credit substitute, or asset- or mortgage-backed security that is retained, assumed, or issued in connection with an asset securitization and that was rated with a reasonable expectation that, in the near future:

(A) The position would be sold to investors relying on the rating; or

(B) A third party would, in reliance on the rating, enter into a transaction such as a purchase, loan or repurchase agreement involving the position.

(2) *Risk-weighted asset amount.* Except as otherwise provided in sections 3(d)(3) and (4) of this appendix A, to calculate the risk-weighted asset amount for a recourse obligation or direct credit substitute, multiply the amount of assets from which risk of credit loss is directly or indirectly retained or assumed, by the appropriate risk weight using the criteria regarding obligors, guarantors, and collateral listed in section 3(a) of this appendix A. For purposes of this section 3(d) of this appendix A, the amount of assets from which risk of credit loss is directly or indirectly retained or assumed means:

(i) For a financial guarantee-type standby letter of credit, surety arrangement, guarantee, or irrevocable guarantee-type instrument, the amount of the assets that the direct credit substitute fully or partially supports;

(ii) For a subordinated interest or security, the amount of the subordinated interest or security plus all more senior interests or securities;

(iii) For mortgage servicing rights that are recourse obligations or direct credit substitutes, the outstanding amount of the loans serviced;

(iv) For representations and warranties (other than standard representations and warranties), the amount of the assets subject to the representations or warranties;

(v) For loans on lines of credit that provide credit enhancement for the financial obligations of an account party, the amount of the enhanced financial obligations;

(vi) For loans strips, the amount of the loans; and

(vii) For assets sold with recourse, the amount of assets from which risk of credit loss is directly or indirectly retained or assumed, less any applicable recourse liability account established in accordance with generally accepted accounting principles.

(3) *Investment grade recourse obligations, direct credit substitutes, and asset-and mortgage-backed securities.* (i) *Eligibility.* A traded position is eligible for the treatment described in this section 3(d)(3) of this appendix A if it has been rated investment grade by a nationally-recognized statistical rating organization. A recourse obligation or direct credit substitute that is not a traded position is eligible for the treatment described in this section 3(d)(3) of this

[16] Participations in performance-based standby letters of credit are treated in accordance with section 3(d) of this appendix A.

[17] Participations in commitments are treated in accordance with section 3(d) of this appendix A.

appendix A if it has been rated investment grade by two nationally-recognized statistical rating organizations, the ratings are publicly available, the ratings are based on the same criteria used to rate securities sold to the public, and the recourse obligation or direct credit substitute provide credit enhancement to a securitization in which at least one position is traded.

(ii) *Highest investment grade.* To calculate the risk-weighted asset amount for a recourse obligation, direct credit substitute, or asset-or mortgage-backed security that is rated in the highest investment grade category, multiply the face amount of the position by a risk weight of 20 percent.

(iii) *Other investment grade.*

[Option 1—Face Value Treatment] To calculate the risk-weighted asset amount for a recourse obligation, direct credit substitute, or asset- or mortgage-backed security that is rated investment grade, multiply the face amount of the position by a risk weight of 100 percent.

[Option 2—Modified Gross-Up] To calculate the risk-weighted asset amount for a recourse obligation, direct credit substitute, or asset- or mortgage-backed security that is rated investment grade, multiply the amount of assets from which risk of credit loss is directly or indirectly retained or assumed by a risk weight of 50 percent.

(4) *Participations.* The risk-weighted asset amount for a participation interest in a direct credit substitute is calculated as follows:

(i) Determine the risk-weighted asset amount for the direct credit substitute as if the bank held all of the interests in the participation.

(ii) Multiply the risk-weighted asset amount determined under section 3(d)(4)(i) of this appendix A by the percentage of the bank's participation interest.

(iii) If the bank is exposed to more than its *pro rata* share of the risk of credit loss on the direct credit substitute (*e.g.*, the bank remains secondarily liable on participations held by others), add to the amount computed under section 3(d)(4)(ii) of this appendix A an amount computed as follows: multiply the amount of the direct credit substitute by the percentage of the direct credit substitute held by others and then multiply the result by the lesser of the risk-weight appropriate for the holders of those interests or the risk weight appropriate for the direct credit substitute.

(5) *Limitations on risk-based capital requirements.* (i) *Low-level recourse.* If the maximum contractual liability or exposure to credit loss retained or assumed by a bank in connection with a recourse obligation or a direct credit substitute is less than the effective risk-based capital requirement for the enhanced assets, the risk-based capital requirement is limited to the maximum contractual liability or exposure to loss, less any recourse liability account established in accordance with generally accepted accounting principles. This limitation does not apply to assets sold with implicit recourse.

(ii) *Mortgage-related securities or participation certificates retained in a mortgage loan swap.* If a bank holds a mortgage-related security or a participation certificate as a result of a mortgage loan swap with recourse, capital is required to support the recourse obligation plus the percentage of the mortgage-related security or participation certificate that is not protected against risk of loss by the recourse obligation. The total amount of capital required for the on-balance sheet asset and the recourse obligation, however, is limited to the capital requirement for the underlying loans, calculated as if the bank continued to hold these loans as an on-balance sheet asset.

(iii) *Related on-balance sheet assets.* To the extent that an asset is included in the calculation of the risk-based capital requirement under this section 3(d) of this appendix A and may also be included as an on-balance sheet asset, the asset is risk-weighted only under this section 3(d) of this appendix A except that mortgage servicing assets and similar arrangements with embedded recourse obligations or direct credit substitutes are risk-weighted as on-balance sheet assets and related recourse obligations and direct credit substitutes are risk-weighted under this section 3(d) of this appendix A.

* * * * *

3. In appendix A, Table 2, item 1 under "100 Percent Conversion Factor" is revised to read as follows:

* * * * *

Table 2—Credit Conversion Factors For Off-Balance Sheet Items

100 Percent Conversion Factor

1. [Reserved]

* * * * *

Dated: October 22, 1997.

Eugene A. Ludwig,

Comptroller of the Currency.

Federal Reserve System

12 CFR Chapter II

For the reasons set forth in the joint preamble, parts 208 and 225 of chapter II of title 12 of the Code of Federal Regulations are proposed to be amended as follows:

PART 208—MEMBERSHIP OF STATE BANKING INSTITUTIONS IN THE FEDERAL RESERVE SYSTEM (REGULATION H)

1. The authority citation for part 208 continues to read as follows:

Authority: 12 U.S.C. 24, 36, 92a, 93a, 248(a), 248(c), 321–338a, 371d, 461, 481-486, 601, 611, 1814, 1816, 1818, 1820(d)(9), 1823(j), 1828(o), 1831o, 1831p-1,1831 r-1, 1835a, 1882, 2901–2907, 3105, 3310, 3331–3351, and 3906–3909; 15 U.S.C. 78b, 78l(b), 78l(g), 78l(i), 78o-4(c)(5), 78q, 78q-1, and 78w; 31 U.S.C. 5318; 42 U.S.C. 4012a, 4104a, 4104b, 4106, and 4128.

2. In appendix A to part 208, section *III*.B. is amended by revising paragraph 3. and in paragraph 4., footnote 24 is redesignated as footnote 28. The revision reads as follows:

Appendix A to Part 208—Capital Adequacy Guidelines for State Member Banks: Risk-Based Measure

* * * * *

III. * * *

B. * * *

3. *Recourse obligations, direct credit substitutes, and asset -and mortgage-backed securities.* Direct credit substitutes, assets transferred with recourse, and securities issued in connection with asset securitizations are treated as described below.

(a) *Definitions*— (1) *Direct credit substitute means an arrangement in which a bank assumes,* in form or in substance, any risk of credit loss directly or indirectly associated with a *third-party* asset or other financial claim, that exceeds the bank's *pro rata* share of the asset or claim. If the bank has no claim on the asset, then the assumption of *any* risk of loss is a direct credit substitute. Direct credit substitutes include, but are not limited to:

(i) Financial guarantee-type standby letters of credit that support financial claims on the account party;

(ii) Guarantees, surety arrangements, and irrevocable guarantee-type instruments backing financial claims such as outstanding securities, loans, or other financial liabilities, or that back off-balance-sheet items against which risk-based capital must be maintained;

(iii) Purchased subordinated interests or securities that absorb more than their *pro rata* share of losses from the underlying assets;

(iv) Loans or lines of credit that provide credit enhancement for the financial obligations of an account party; and

(v) Purchased loan servicing assets if the servicer is responsible for credit losses associated with the loans being serviced (other than mortgage servicer cash advances as defined in paragraph *III*.B.3.(a)(3) of this appendix A), or if the servicer makes or assumes representations and warranties on the loans other than standard representations and warranties as defined in paragraph *III*.B.3.(a)(6) of this appendix A.

(2) *Financial guarantee-type standby letter of credit* means any letter of credit or similar arrangement, however named or described, that represents an irrevocable obligation to the beneficiary on the part of the issuer:

(i) To repay money borrowed by, advanced to, or for the account of, the account party; or

(ii) To make payment on account of any indebtedness undertaken by the account party in the event that the account party fails to fulfill its obligation to the beneficiary.

(3) *Mortgage servicer cash advance* means funds that a residential mortgage loan servicer advances to ensure an uninterrupted flow of payments or the timely collection of residential mortgage loans, including disbursements made to cover foreclosure costs or other expenses arising from a mortgage loan to facilitate its timely collection. A servicer cash advance is not a recourse obligation or a direct credit substitute if the mortgage servicer is entitled to full reimbursement or, for any one residential mortgage loan, nonreimbursable

advances are contractually limited to an insignificant amount of the outstanding principal on that loan.

(4) *Rated* means, with respect to an instrument or obligation, that the instrument or obligation has received a credit rating from a nationally-recognized statistical rating organization. An instrument or obligation is rated investment grade if it has received a credit rating that falls within one of the four highest rating categories used by the organization, e.g., at least BBB or its equivalent. An instrument or obligation is rated in the highest investment grade if it has received a credit rating that falls within the highest rating category used by the organization.

(5) *Recourse* means an arrangement in which a bank *retains*, in form or in substance, any risk of credit loss directly or indirectly associated with a transferred asset that exceeds a *pro rata* share of the bank's claim on the asset. If a bank has no claim on a transferred asset, then the retention of any risk of loss is recourse. A recourse obligation typically arises when an institution transfers assets and retains an obligation to repurchase the assets or absorb losses due to a default of principal or interest or any other deficiency in the performance of the underlying obligor or some other party. Recourse may exist implicitly where a bank provides credit enhancement beyond any contractual obligation to support assets it has sold. Recourse obligations include, but are not limited to:

(i) Representations and warranties on the transferred assets other than standard representations and warranties as defined in paragraph *III*.B.3.(a)(6) of this appendix A;

(ii) Retained loan servicing assets if the servicer is responsible for losses associated with the loans being serviced other than mortgage servicer cash advances as defined in paragraph *III*.B.3.(a)(3) of this appendix A;

(iii) Retained subordinated interests or securities that absorb more than their *pro rata* share of losses from the underlying assets;

(iv) Assets sold under an agreement to repurchase; and

(v) Loan strips sold without direct recourse where the maturity of the transferred loan that is drawn is shorter than the maturity of the commitment.

(6) *Standard representations and warranties* means contractual provisions that a bank extends when it transfers assets (including loan servicing assets) or assumes when it purchases loan servicing assets. To qualify as a standard representation or warranty, a contractual provision must:

(i) Refer to facts that the seller or servicer can verify, and has verified with reasonable due diligence, prior to the time that assets are transferred (or servicing assets are acquired);

(ii) Refer to a condition that is within the control of the seller or servicer; or

(iii) Provide for the return of assets in the event of fraud or documentation deficiencies.

(7) *Traded position* means a recourse obligation, direct credit substitute, or asset- or mortgage-backed security that is retained, assumed, or issued in connection with an asset securitization and that is rated with a reasonable expectation that, in the near future:

(i) The position would be sold to investors relying on the rating; or

(ii) A third party would, in reliance on the rating, enter into a transaction such as a purchase, loan, or repurchase agreement involving the position.

(b) *Amount of position to be included in risk-weighted assets*—(1) *Determining the credit equivalent amount of recourse obligations and direct credit substitutes.* The credit equivalent amount for a recourse obligation or direct credit substitute (except as otherwise provided in paragraph *III*.B.3.(b)(2) of this appendix A) is the full amount of the credit enhanced assets from which risk of credit loss is directly or indirectly retained or assumed. This credit equivalent amount is assigned to the risk weight appropriate to the obligor, or if relevant, the guarantor or nature of any collateral. Thus, a bank that extends a partial direct credit substitute, e.g., a standby letter of credit that absorbs the first 10 percent of loss on a transaction, must maintain capital against the full amount of the assets being supported. Furthermore, for direct credit substitutes that are on-balance sheet, e.g., purchased subordinated securities, banks must maintain capital against the amount of the direct credit substitutes and the full amounts of the assets being supported, *i.e.*, all more senior positions. This treatment is subject to the low-level recourse rule discussed in section *III*.B.3.(c)(1) of this appendix A. For purposes of this appendix A, the full amount of the credit enhanced assets from which risk of credit loss is directly or indirectly retained or assumed means for:

(i) A financial guarantee-type standby letter of credit, surety arrangement, guarantee, or irrevocable guarantee-type instruments, the full amount of the assets that the direct credit substitute fully or partially supports;

(ii) A subordinated interest or security, the amount of the subordinated interest or security plus all more senior interests or securities;

(iii) Mortgage servicing assets that are recourse obligations or direct credit substitutes, the outstanding amount of the loans serviced;

(iv) Representations and warranties (other than standard representations and warranties), the amount of the assets subject to the representations or warranties;

(v) Loans or lines of credit that provide credit enhancement for the financial obligations of an account party, the full amount of the enhanced financial obligations;

(vi) Loans strips, the amount of the loans;

(vii) For assets sold with recourse, the amount of assets from which risk of loss is directly or indirectly retained, less any applicable recourse liability account established in accordance with generally accepted accounting principles; and

(viii) Other types of recourse obligations or direct credit substitutes should be treated in accordance with the principles contained in section *III*.B.3. of this appendix A.

(2) *Determining the credit risk weight of investment grade recourse obligations, direct credit substitutes, and asset- and mortgage-backed securities.* A traded position is eligible for the risk-based capital treatment described in this paragraph if it has been rated at least investment grade by a nationally-recognized statistical rating organization. A recourse obligation or direct credit substitute that is not a traded position is eligible for the treatment described in this paragraph if it has been rated at least investment grade by two nationally-recognized statistical rating organizations, the ratings are publicly available, the ratings are based on the same criteria used to rate securities sold to the public, and the recourse obligation or direct credit substitute provides credit enhancement to a securitization in which at least one position is traded.

(i) *Highest investment grade.* Except as otherwise provided in this section *III*. of this appendix A, the face amount of a recourse obligation, direct credit substitute, or an asset- or mortgage-backed security that is rated in the highest investment grade category is assigned to the 20 percent risk category.

(ii) *Other investment grade.* [Option 1—Face Value Treatment] Except as otherwise provided in this section III. of this appendix A, the face amount of a recourse obligation, direct credit substitute, or an asset- or mortgage-backed security that is rated investment grade is assigned to the 100 percent risk category.

[Option 2—Modified Gross-Up] Except as otherwise provided in this section III. of this appendix A, for a recourse obligation, direct credit substitute, or an asset- or mortgage-backed security that is rated investment grade, the full amount of the credit enhanced assets from which risk of credit loss is directly or indirectly retained or assumed by the bank is assigned to the 50 percent risk category, regardless of the face amount of the bank's risk position.

(3) *Risk participations and syndications in direct credit substitutes*—(i) In the case of direct credit substitutes in which a risk participation [23] has been conveyed, the full amount of the assets that are supported, in whole or in part, by the credit enhancement are converted to a credit equivalent amount at 100 percent. However, the *pro rata* share of the credit equivalent amount that has been conveyed through a risk participation is assigned to whichever risk category is lower: the risk category appropriate to the obligor, after considering any relevant guarantees or collateral, or the risk category appropriate to the institution acquiring the participation.[24] Any remainder is assigned to the risk category appropriate to the obligor, guarantor, or collateral. For example, the *pro rata* share of the full amount of the assets supported, in whole or in part, by a direct credit substitute conveyed as a risk participation to a U.S. domestic depository

[23] That is, a participation in which the originating bank remains liable to the beneficiary for the full amount of the direct credit substitute if the party that has acquired the participation fails to pay when the instrument is drawn.

[24] A risk participation in bankers acceptances conveyed to other institutions is also assigned to the risk category appropriate to the institution acquiring the participation or, if relevant, the guarantor or nature of the collateral.

institution or foreign bank is assigned to the 20 percent risk category.[25]

(ii) The capital treatment for risk participations, either conveyed or acquired, and syndications in direct credit substitutes that are associated with an asset securitization and are rated at least investment grade is set forth in paragraph *III*.B.3.(b)(2) of this appendix A. A lower risk category may be applicable depending upon the obligor or nature of the institution acquiring the participation.

(iii) In the case of direct credit substitutes in which a risk participation has been acquired, the acquiring bank's percentage share of the direct credit substitute is multiplied by the full amount of the assets that are supported, in whole or in part, by the credit enhancement and converted to a credit equivalent amount at 100 percent. The credit equivalent amount of an acquisition of a risk participation in a direct credit substitute is assigned to the risk category appropriate to the account party obligor or, if relevant, the nature of the collateral or guarantees.

(iv) In the case of direct credit substitutes that take the form of a syndication where each bank is obligated only for its *pro rata* share of the risk and there is no recourse to the originating bank, each bank will only include its pro rata share of the assets supported, in whole or in part, by the direct credit substitute in its risk-based capital calculation.[26]

(c) *Limitations on risk-based capital requirements*—(1) *Low-level recourse*. If the maximum contractual liability or exposure to loss retained or assumed by a bank in connection with a recourse obligation or a direct credit substitute is less than the effective risk-based capital requirement for the enhanced assets, the risk-based capital requirement is limited to the maximum contractual liability or exposure to loss, less any recourse liability account established in accordance with generally accepted accounting principles. This limitation does not apply to assets sold with implicit recourse.

(2) *Mortgage-related securities or participation certificates retained in a mortgage loan swap*. If a bank holds a mortgage-related security or a participation certificate as a result of a mortgage loan swap with recourse, capital is required to support the recourse obligation plus the percentage of the mortgage-related security or participation certificate that is not covered by the recourse obligation. The total amount of capital required for the on-balance sheet asset and the recourse obligation, however, is limited to the capital requirement for the underlying loans, calculated as if the bank continued to hold these loans as an on-balance sheet asset.

(3) *Related on-balance sheet assets*. If a recourse obligation or direct credit substitute subject to this section *III*.B.3. of this appendix A also appears as a balance sheet asset, the balance sheet asset is not included in a bank's risk-weighted assets, except in the case of mortgage servicing assets and similar arrangements with embedded recourse obligations or direct credit substitutes. In such cases, both the on-balance sheet assets and the related recourse obligations and direct credit substitutes are incorporated into the risk-based capital calculation.

(d) *Privately-issued mortgage-backed securities*. Generally, a privately-issued mortgage-backed security meeting certain criteria, set forth in the accompanying footnote,[27] is essentially treated as an indirect holding of the underlying assets, and assigned to the same risk category as the underlying assets, but in no case to the zero percent risk category. However, any class of a privately-issued mortgage-backed security whose structure does not qualify it to be regarded as an indirect holding of the underlying assets or that can absorb more than its *pro rata* share of loss without the whole issue being in default (for example, a so-called subordinated class) is treated in accordance with section *III*.B.3.(b) of this appendix A. Furthermore, all stripped mortgage-backed securities, including interest-only strips (IOs), principal-only strips (POs), and similar instruments, are assigned to the 100 percent risk weight category, regardless of the issuer or guarantor.

* * * * *

3. In appendix A to part 208, sections *III*.C.1. through 3., footnotes 25 through 37 are redesignated as footnotes 29 through 41 and newly redesignated footnote 39 and section *III*.C.4. are revised to read as follows:

* * * * *

III. * * *

C. * * *

3. * * * [39] * * *

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4. *Category 4: 100 percent*. (a) All assets not included in the categories above are assigned to this category, which comprises standard risk assets. The bulk of the assets typically found in a loan portfolio would be assigned to the 100 percent category.

(b) This category includes long-term claims on, and the portions of long-term claims that are guaranteed by, non-OECD banks, and all claims on non-OECD central governments that entail some degree of transfer risk.[42] This category includes all claims on foreign and domestic private-sector obligors not included in the categories above (including loans to nondepository financial institutions and bank holding companies); claims on commercial firms owned by the public sector; customer liabilities to the bank on acceptances outstanding involving standard risk claims;[43] investments in fixed assets, premises, and other real estate owned; common and preferred stock of corporations, including stock acquired for debts previously contracted; commercial and consumer loans (except those assigned to lower risk categories due to recognized guarantees or collateral and loans secured by residential property that qualify for a lower risk weight); and all stripped mortgage-backed securities and similar instruments.

(c) Also included in this category are industrial-development bonds and similar obligations issued under the auspices of state or political subdivisions of the OECD-based

[25] Risk participations with a remaining maturity of over one year that are conveyed to non-OECD banks are to be assigned to the 100 percent risk category, unless a lower risk category is appropriate to the obligor, guarantor, or collateral.

[26] For example, if a bank has a 10 percent share of a $10 syndicated direct credit substitute that provides credit support to a $100 loan, then the bank's $1 *pro rata* share in the enhancement means that a $10 *pro rata* share of the loan is included in risk weighted assets.

[27] A privately-issued mortgage-backed security may be treated as an indirect holding of the underlying assets provided that: (1) The underlying assets are held by an independent trustee and the trustee has a first priority, perfected security interest in the underlying assets on behalf of the holders of the security; (2) either the holder of the security has an undivided *pro rata* ownership interest in the underlying mortgage assets or the trust or single purpose entity (or conduit) that issues the security has no liabilities unrelated to the issued securities; (3) the security is structured such that the cash flow from the underlying assets in all cases fully meets the cash flow requirements of the security without undue reliance on any reinvestment income; and (4) there is no material reinvestment risk associated with any funds awaiting distribution to the holders of the security. In addition, if the underlying assets of a mortgage-backed security are composed of more than one type of assets, for example, U.S. Government-sponsored agency securities and privately-issued pass-through securities that qualify for the 50 percent risk category, the entire mortgage-backed security is generally assigned to the category appropriate to the highest risk-weighted asset underlying the issue. Thus, in this example, the security would receive the 50 percent risk weight appropriate to the privately-issued pass-through securities.

[39] a. Loans that qualify as loans secured by one- to four-family residential properties or multifamily residential properties are listed in the instructions to the commercial bank call report. In addition, for risk-based capital purposes, loans secured by one- to four-family residential properties include loans to builders with substantial project equity for the construction of one-to four-family residences that have been presold under firm contracts to purchasers who have obtained firm commitments for permanent qualifying mortgage loans and have made substantial earnest-money deposits. b. The instructions to the call report also discuss the treatment of loans, including multifamily housing loans, that are sold subject to a *pro rata* loss-sharing arrangement. Such an arrangement should be treated by the selling bank as sold to the extent that the sales agreement provides for the purchaser of the loan to share in any loss incurred on the loan on a *pro rata* basis with the selling bank. In such a transaction, from the stand-point of the selling bank, the portion of the loan that is treated as sold is not subject to the risk-based capital standards. In connection with sales of multifamily housing loans in which the purchaser of a loan shares in any loss incurred on the loan with the selling institution on other than a *pro rata* basis, the selling bank must treat these other loss-sharing arrangements in accordance with section *III*.B.3. of this appendix A.

[42] Such assets include all nonlocal-currency claims on, and the portions of claims that are guaranteed by, non-OECD central governments and those portions of local-currency claims on, or guaranteed by, non-OECD central governments that exceed the local-currency liabilities held by subsidiary depository institutions.

[43] Customer liabilities on acceptances outstanding involving nonstandard risk claims, such as claims on U.S. depository institutions, are assigned to the risk category appropriate to the identity of the obligor or, if relevant, the nature of the collateral or guarantees backing the claims. Portions of acceptances conveyed as risk participations to U.S. depository institutions or foreign banks are assigned to the 20 percent risk category appropriate to short-term claims guaranteed by U.S. depository institutions and foreign banks.

group of countries for the benefit of a private party or enterprise where that party or enterprise, not the government entity, is obligated to pay the principal and interest, and all obligations of states or political subdivisions of countries that do not belong to the OECD-based group.

(d) The following assets also are assigned a risk weight of 100 percent if they have not been deducted from capital: investments in unconsolidated companies, joint ventures, or associated companies; instruments that qualify as capital issued by other banking organizations; and any intangibles, including those that may have been grandfathered into capital.

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4. In appendix A to part 208, the introductory paragraph in section *III*.D. and section *III*.D.1. are revised to read as follows:

* * * * *

III. * * *

D. Off-Balance Sheet Items

The face amount of an off-balance sheet item is generally incorporated into risk-weighted assets in two steps. The face amount is first multiplied by a credit conversion factor, except for direct credit substitutes and recourse obligations as discussed in section *III*.D.1. of this appendix A. The resultant credit equivalent amount is assigned to the appropriate risk category according to the obligor or, if relevant, the guarantor or the nature of the collateral.[44] Attachment IV to this appendix A sets forth the conversion factors for various types of off-balance-sheet items.

1. *Items with a 100 percent conversion factor.* (a) Except as otherwise provided in section *III*.B.3. of this appendix A, the full amount of an asset or transaction supported, in whole or in part, by a direct credit substitute or a recourse obligation. Direct credit substitutes and recourse obligations are defined in section *III*.B.3. of this appendix A.

(b) Sale and repurchase agreements, if not already included on the balance sheet, and forward agreements. Forward agreements are legally binding contractual obligations to purchase assets with certain drawdown at a specified future date. Such obligations include forward purchases, forward forward deposits placed,[45] and partly-paid shares and securities; they do not include commitments to make residential mortgage loans or forward foreign exchange contracts.

(c) Securities lent by a bank are treated in one of two ways, depending upon whether the lender is at risk of loss. If a bank, as agent for a customer, lends the customer's securities and does not indemnify the customer against loss, then the transaction is excluded from the risk-based capital calculation. If, alternatively, a bank lends its own securities or, acting as agent for a customer, lends the customer's securities and indemnifies the customer against loss, the transaction is converted at 100 percent and assigned to the risk weight category appropriate to the obligor or, if applicable to any collateral delivered to the lending bank the independent custodian acting on the lending bank's behalf. Where a bank is acting as agent for a customer in a transaction involving the lending or sale of securities that is collateralized by cash delivered to the bank, the transaction is deemed to be collateralized by cash on deposit in the bank for purposes of determining the appropriate risk-weight category, provided that any indemnification is limited to no more than the difference between the market value of the securities and the cash collateral received and any reinvestment risk associated with that cash collateral is borne by the customer.

* * * * *

[44] The sufficiency of collateral and guarantees for off-balance-sheet items is determined by the market value of the collateral of the amount of the guarantee in relation to the face amount of the item, except for derivative contracts, for which this determination is generally made in relation to the credit equivalent amount. Collateral and guarantees are subject to the same provisions noted under section *III*.B. of this appendix A.

[45] Forward forward deposits accepted are treated as interest rate contracts.

PART 225—BANK HOLDING COMPANIES AND CHANGE IN BANK CONTROL (REGULATION Y)

1. The authority citation for part 225 continues to read as follows:

Authority: 12 U.S.C. 1817(j)(13), 1818, 1828(o), 1831i, 1831p–1, 1843(c)(8), 1844(b), 1972(1), 3106, 3108, 3310, 3331–3351, 3907, and 3909.

2. In appendix A to part 225, section III.*B*. is amended by revising paragraph 3. and in paragraph 4., footnote 27 is redesignated as footnote 31. The revision reads as follows:

Appendix A to Part 225—Capital Adequacy Guidelines for Bank Holding Companies: Risk-Based Measure

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III. * * *

B. * * *

3. *Recourse obligations, direct credit substitutes, and asset- and mortgage-backed securities.* Direct credit substitutes, assets transferred with recourse, and securities issued in connection with asset securitizations are treated as described below.

(a) *Definitions*—(1) *Direct credit substitute* means an arrangement in which a banking organization *assumes*, in form or in substance, any risk of credit loss directly or indirectly associated with a *third-party* asset or other financial claim, that exceeds the banking organization's *pro rata* share of the asset or claim. If the banking organization has no claim on the asset, then the assumption of *any* risk of loss is a direct credit substitute. Direct credit substitutes include, but are not limited to:

(i) Financial guarantee-type standby letters of credit that support financial claims on the account party;

(ii) Guarantees, surety arrangements, and irrevocable guarantee-type instruments backing financial claims such as outstanding securities, loans, or other financial liabilities, or that back off-balance-sheet items against which risk-based capital must be maintained;

(iii) Purchased subordinated interests or securities that absorb more than their *pro rata* share of losses from the underlying assets;

(iv) Loans or lines of credit that provide credit enhancement for the financial obligations of an account party; and

(v) Purchased loan servicing assets if the servicer is responsible for credit losses associated with the loans being serviced (other than mortgage servicer cash advances as defined in paragraph III.*B*.3.(a)(3) of this appendix A), or if the servicer makes or assumes representations and warranties on the loans other than standard representations and warranties as defined in paragraph III.*B*.3.(a)(6) of this appendix A.

(2) *Financial guarantee-type standby letter of credit* means any letter of credit or similar arrangement, however named or described, that represents an irrevocable obligation to the beneficiary on the part of the issuer:

(i) To repay money borrowed by, advanced to, or for the account of, the account party; or

(ii) To make payment on account of any indebtedness undertaken by the account party in the event that the account party fails to fulfill its obligation to the beneficiary.

(3) *Mortgage servicer cash advance* means funds that a residential mortgage loan servicer advances to ensure an uninterrupted flow of payments or the timely collection of residential mortgage loans, including disbursements made to cover foreclosure costs or other expenses arising from a mortgage loan to facilitate its timely collection. A servicer cash advance is not a recourse obligation or a direct credit substitute if the mortgage servicer is entitled to full reimbursement or, for any one residential mortgage loan, nonreimbursable advances are contractually limited to an insignificant advances of the outstanding principal on that loan.

(4) *Rated* means, with respect to an instrument or obligation, that the instrument or obligation has received a credit rating from a nationally-recognized statistical rating organization. An instrument or obligation is rated investment grade if it has received a credit rating that falls within one of the four highest rating categories used by the organization. An instrument or obligation is rated in the highest investment grade if it has received a credit rating that falls within the highest rating category used by the organization.

(5) *Recourse* means an arrangement in which a banking organization *retains*, in form or in substance, any risk of credit loss directly or indirectly associated with a transferred asset that exceeds a *pro rata* share of the banking organization's claim on the asset. If a banking organization has no claim on a transferred asset, then the retention of any risk of loss is recourse. A recourse obligation typically arises when an institution transfers assets and retains an obligation to repurchase the assets or absorb losses due to a default of principal or interest or any other deficiency in the performance of the underlying obligor or some other party. Recourse may exist implicitly where a banking organization provides credit enhancement beyond any contractual

obligation to support assets it has sold. Recourse obligations include, but are not limited to:

(i) Representations and warranties on the transferred assets other than standard representations and warranties as defined in paragraph III.*B*.3.(a)(6) of this appendix A;

(ii) Retained loan servicing assets if the servicer is responsible for losses associated with the loans being serviced other than mortgage servicer cash advances as defined in paragraph III.*B*.3.(a)(3) of this appendix A;

(iii) Retained subordinated interests or securities that absorb more than their *pro rata* share of losses from the underlying assets;

(iv) Assets sold under an agreement to repurchase; and

(v) Loan strips sold without direct recourse where the maturity of the transferred loan that is drawn is shorter than the maturity of the commitment.

(6) *Standard representations and warranties* means contractual provisions that a banking organization extends when it transfers assets (including loan servicing assets) or assumes when it purchases loan servicing assets. To qualify as a standard representation or warranty, a contractual provision must:

(i) Refer to facts that the seller or servicer can verify, and has verified with reasonable due diligence, prior to the time that assets are transferred (or servicing assets are acquired);

(ii) Refer to a condition that is within the control of the seller or servicer; or

(iii) Provide for the return of assets in the event of fraud or documentation deficiencies.

(7) *Traded position* means a recourse obligation, direct credit substitute, or asset- or mortgage-backed security that is retained, assumed, or issued in connection with an asset securitization and that is rated with a reasonable expectation that, in the near future:

(i) The position would be sold to investors relying on the rating; or

(ii) A third party would, in reliance on the rating, enter into a transaction such as a purchase, loan, or repurchase agreement involving the position.

(b) *Amount of position to be included in risk-weighted assets*—(1) *Determining the credit equivalent amount of recourse obligations and direct credit substitutes.* The credit equivalent amount for a recourse obligation or direct credit substitute (except as otherwise provided in paragraph III.*B*.3.(b)(2) of this appendix A) is the full amount of the credit enhanced assets from which risk of credit loss is directly or indirectly retained or assumed. This credit equivalent amount is assigned to the risk weight appropriate to the obligor, or if relevant, the guarantor or nature of any collateral. Thus, a banking organization that extends a partial direct credit substitute, e.g., a standby letter of credit that absorbs the first 10 percent of loss on a transaction, must maintain capital against the full amount of the assets being supported. Furthermore, for direct credit substitutes that are on-balance sheet, e.g., purchased subordinated securities, banking organizations must maintain capital against the amount of the direct credit substitutes and the full amounts of the assets being supported, i.e., all more senior positions. This treatment is subject to the low-level recourse rule discussed in paragraph III.*B*.3.(c)(1) of this appendix A. For purposes of this appendix A, the full amount of the credit enhanced assets from which risk of credit loss is directly or indirectly retained or assumed means for:

(i) A financial guarantee-type standby letter of credit, surety arrangement, guarantee, or irrevocable guarantee-type instruments, the full amount of the assets that the direct credit substitute fully or partially supports;

(ii) A subordinated interest or security, the amount of the subordinated interest or security plus all more senior interests or securities;

(iii) Mortgage servicing assets that are recourse obligations or direct credit substitutes, the outstanding amount of the loans serviced;

(iv) Representations and warranties (other than standard representations and warranties), the amount of the assets subject to the representations or warranties;

(v) Loans or lines of credit that provide credit enhancement for the financial obligations of an account party, the full amount of the enhanced financial obligations;

(vi) Loans strips, the amount of the loans;

(vii) For assets sold with recourse, the amount of assets from which risk of loss is directly or indirectly retained, less any applicable recourse liability account established in accordance with generally accepted accounting principles; and

(viii) Other types of recourse obligations or direct credit substitutes should be treated in accordance with the principles contained in paragraph III.*B*.3.(b)(3) of this appendix A.

(2) *Determining the credit risk weight of investment grade recourse obligations, direct credit substitutes, and asset- and mortgage-backed securities.* A traded position is eligible for the risk-based capital treatment described in this paragraph if it has been rated at least investment grade by a nationally-recognized statistical rating organization. A recourse obligation or direct credit substitute that is not a traded position is eligible for the treatment described in this paragraph if it has been rated at least investment grade by two nationally-recognized statistical rating organizations, the ratings are publicly available, the ratings are based on the same criteria used to rate securities sold to the public, and the recourse obligation or direct credit substitute provides credit enhancement to a securitization in which at least one position is traded.

(i) *Highest investment grade.* Except as otherwise provided in section III. of this appendix A, the face amount of a recourse obligation, direct credit substitute, or an asset- or mortgage-backed security that is rated in the highest investment grade category is assigned to the 20 percent risk category.

(ii) *Other investment grade.* [Option 1—Face Value Treatment] Except as otherwise provided in this section III. of this appendix A, the face amount of a recourse obligation, direct credit substitute, or an asset- or mortgage-backed security that is rated investment grade is assigned to the 100 percent risk category.

[Option 2—Modified Gross-Up] Except as otherwise provided in section III. of this appendix A, for a recourse obligation, direct credit substitute, or an asset or mortgage-backed security that is rated investment grade, the *full* amount of the credit enhanced assets from which risk of credit loss is directly or indirectly retained or assumed by the banking organization is assigned to the 50 percent risk category, regardless of the face amount of the banking organization's risk position.

(3) *Risk participations and syndications in direct credit substitutes*—(i) In the case of direct credit substitutes in which a risk participation [26] has been conveyed, the full amount of the assets that are supported, in whole or in part, by the credit enhancement are converted to a credit equivalent amount at 100 percent. However, the *pro rata* share of the credit equivalent amount that has been conveyed through a risk participation is assigned to whichever risk category is lower: the risk category appropriate to the obligor, after considering any relevant guarantees or collateral, or the risk category appropriate to the institution acquiring the participation.[27] Any remainder is assigned to the risk category appropriate to the obligor, guarantor, or collateral. For example, the *pro rata* share of the full amount of the assets supported, in whole or in part, by a direct credit substitute conveyed as a risk participation to a U.S. domestic depository institution or foreign bank is assigned to the 20 percent risk category.[28]

(ii) The capital treatment for risk participations, either conveyed or acquired, and syndications in direct credit substitutes that are associated with an asset securitization and are rated at least investment grade is set forth in paragraph III.*B*.3.(b)(2) of this appendix A. A lower risk category may be applicable depending upon the obligor or nature of the institution acquiring the participation.

(iii) In the case of direct credit substitutes in which a risk participation has been acquired, the acquiring banking organization's percentage share of the direct credit substitute is multiplied by the full amount of the assets that are supported, in whole or in part, by the credit enhancement and converted to a credit equivalent amount at 100 percent. The credit equivalent amount of an acquisition of a risk participation in a direct credit substitute is assigned to the risk category appropriate to the account party obligor or, if relevant, the nature of the collateral or guarantees.

[26] That is, a participation in which the originating banking organization remains liable to the beneficiary for the full amount of the direct credit substitute if the party that has acquired the participation fails to pay when the instrument is drawn.

[27] A risk participation in bankers acceptances conveyed to other institutions is also assigned to the risk category appropriate to the institution acquiring the participation or, if relevant, the guarantor or nature of the collateral.

[28] Risk participations with a remaining maturity of over one year that are conveyed to non-OECD banks are to be assigned to the 100 percent risk category, unless a lower risk category is appropriate to the obligor, guarantor, or collateral.

(iv) In the case of direct credit substitutes that take the form of a syndication where each banking organization is obligated only for its *pro rata* share of the risk and there is no recourse to the originating banking organization, each banking organization will only include its *pro rata* share of the assets supported, in whole or in part, by the direct credit substitute in its risk-based capital calculation.[29]

(c) *Limitations on risk-based capital requirements*—(1) *Low-level recourse.* If the maximum contractual liability or exposure to loss retained or assumed by a banking organization in connection with a recourse obligation or a direct credit substitute is less than the effective risk-based capital requirement for the enhanced assets, the risk-based capital requirement is limited to the maximum contractual liability or exposure to loss, less any recourse liability account established in accordance with generally accepted accounting principles. This limitation does not apply to assets sold with implicit recourse.

(2) *Mortgage-related securities or participation certificates retained in a mortgage loan swap.* If a banking organization holds a mortgage-related security or a participation certificate as a result of a mortgage loan swap with recourse, capital is required to support the recourse obligation plus the percentage of the mortgage-related security or participation certificate that is not covered by the recourse obligation. The total amount of capital required for the on-balance sheet asset and the recourse obligation, however, is limited to the capital requirement for the underlying loans, calculated as if the banking organization continued to hold these loans as an on-balance sheet asset.

(3) *Related on-balance sheet assets.* If a recourse obligation or direct credit substitute subject to section *III*.B.3. of this appendix A also appears as a balance sheet asset, the balance sheet asset is not included in a banking organization's risk-weighted assets, except in the case of mortgage servicing assets and similar arrangements with embedded recourse obligations or direct credit substitutes. In such cases, both the on-balance sheet assets and the related recourse obligations and direct credit substitutes are incorporated into the risk-based capital calculation.

(d) *Privately-issued mortgage-backed securities.* Generally, a privately-issued mortgage-backed security meeting certain criteria, set forth in the accompanying footnote,[30] is essentially treated as an indirect holding of the underlying assets, and assigned to the same risk category as the underlying assets, but in no case to the zero percent risk category. However, any class of a privately-issued mortgage-backed security whose structure does not qualify it to be regarded as an indirect holding of the underlying assets or that can absorb more than its *pro rata* share of loss without the whole issue being in default (for example, a so-called subordinated class) is treated in accordance with section III.*B*.3.(b) of this appendix A. Furthermore, all stripped mortgage-backed securities, including (IOs), principal-only strips (POs), and similar instruments, are assigned to the 100 percent risk weight category, regardless of the issuer or guarantor.

* * * * *

3. In appendix A to part 225, sections III.*C*.1. through 3., footnotes 28 through 40 are redesignated as footnotes 32 through 44 and section III.*C*.4. is revised to read as follows:

* * * * *

III. * * *

C. * * *

4. *Category 4: 100 percent.* (a) All assets not included in the categories above are assigned to this category, which comprises standard risk assets. The bulk of the assets typically found in a loan portfolio would be assigned to the 100 percent category.

(b) This category includes long-term claims on, and the portions of long-term claims that are guaranteed by, non-OECD banks, and all claims on non-OECD central governments that entail some degree of transfer risk.[45] This category includes all claims on foreign and domestic private-sector obligors not included in the categories above (including loans to nondepository financial institutions and bank holding companies); claims on commercial firms owned by the public sector; customer liabilities to the bank on acceptances outstanding involving standard risk claims;[46] investments in fixed assets, premises, and other real estate owned; common and preferred stock of corporations, including stock acquired for debts previously contracted; commercial and consumer loans (except those assigned to lower risk categories due to recognized guarantees or collateral and loans secured by residential property that qualify for a lower risk weight); and all stripped mortgage-backed securities and similar instruments.

(c) Also included in this category are industrial-development bonds and similar obligations issued under the auspices of state or political subdivisions of the OECD-based group of countries for the benefit of a private party or enterprise where that party or enterprise, not the government entity, is obligated to pay the principal and interest, and all obligations of states or political subdivisions of countries that do not belong to the OECD-based group.

(d) The following assets also are assigned a risk weight of 100 percent if they have not been deducted from capital: investments in unconsolidated companies, joint ventures, or associated companies; instruments that qualify as capital issued by other banking organizations; and any intangibles, including those that may have been grandfathered into capital.

* * * * *

4. In appendix A to part 225, the introductory paragraph and paragraph 1. in section III.*D*. are revised and footnote 49 is added and reserved to read as follows:

* * * * *

III. * * *

D. Off-Balance Sheet Items

The face amount of an off-balance sheet item is generally incorporated into the risk-weighted assets in two steps. The face amount is first multiplied by a credit conversion factor, except for direct credit substitutes and recourse obligations as discussed in paragraph III.*D*.1. of this appendix A. The resultant credit equivalent amount is assigned to the appropriate risk category according to the obligor or, if relevant, the guarantor or the nature of the collateral.[47] Attachment IV to this appendix A sets forth the conversion factors for various types of off-balance-sheet items.

1. *Items with a 100 percent conversion factor.* (a) Except as otherwise provided in paragraph III.*B*.3. of this appendix A, the full amount of an asset or transaction supported, in whole or in part, by a direct credit

[29] For example, if a banking organization has a 10 percent share of a $10 syndicated direct credit substitute that provides credit support to a $100 loan, then the banking organization $1 *pro rata* share in the enhancement means that a $10 *pro rata* share of the loan is included in risk-weighted assets.

[30] A privately-issued mortgage-backed security may be treated as an indirect holding of the underlying assets provided that: (1) the underlying assets are held by an independent trustee and the trustee has a first priority, perfected security interest in the underlying assets on behalf of the holders of the security; (2) either the holder of the security has an undivided *pro rata* ownership interest in the underlying mortgage assets or the trust or single purpose entity (or conduit) that issues the security has no liabilities unrelated to the issued securities; (3) the security is structured such that the cash flow from the underlying assets in all cases fully meets the cash flow requirements of the security without undue reliance on any reinvestment income; and (4) there is no material reinvestment risk associated with any funds awaiting distribution to the holders of the security. In addition, if the underlying assets of a mortgage-backed security are composed of more than one type of assets, for example, U.S. Government-sponsored agency securities and privately-issued pass-through securities that qualify for the 50 percent risk category, the entire mortgage-backed security is generally assigned to the category appropriate to the highest risk-weighted asset underlying the issue. Thus, in this example, the security would receive the 50 percent risk weight appropriate to the privately-issued pass-through securities.

[45] Such assets include all nonlocal currency claims on, and the portions of claims that are guaranteed by, non-OECD central governments and those portions of local currency claims on, or guaranteed by, non-OECD central governments that exceed the local currency liabilities held by subsidiary depository institutions.

[46] Customer liabilities on acceptances outstanding involving nonstandard risk claims, such as claims on U.S. depository institutions, are assigned to the risk category appropriate to the identity of the obligor or, if relevant, the nature of the collateral or guarantees backing the claims. Portions of acceptances conveyed as risk participations to U.S. depository institutions or foreign banks are assigned to the 20 percent risk category appropriate to short-term claims guaranteed by U.S. depository institutions and foreign banks.

[47] The sufficiency of collateral and guarantees for off-balance-sheet items is determined by the market value of the collateral of the amount of the guarantee in relation to the face amount of the item, except for derivative contracts, for which this determination is generally made in relation to the credit equivalent amount. Collateral and guarantees are subject to the same provisions noted under section III.*B*. of this appendix A.

substitute or a recourse obligation. Direct credit substitutes and recourse obligations are defined in paragraph III.*B*.3. of this appendix A.

(b) Sale and repurchase agreements, if not already included on the balance sheet, and forward agreements. Forward agreements are legally binding contractual obligations to purchase assets with certain drawdown at a specified future date. Such obligations include forward purchases, forward forward deposits placed,[48] and partly-paid shares and securities; they do not include commitments to make residential mortgage loans or forward foreign exchange contracts.

(c) Securities lent by a banking organization are treated in one of two ways, depending upon whether the lender is at risk of loss. If a banking organization, as agent for a customer, lends the customer's securities and does not indemnify the customer against loss, then the transaction is excluded from the risk-based capital calculation. If, alternatively, a bank lends its own securities or, acting as agent for a customer, lends the customer's securities and indemnifies the customer against loss, the transaction is converted at 100 percent and assigned to the risk weight category appropriate to the obligor or, if applicable, to any collateral delivered to the lending banking organization or the independent custodian acting on the lending banking organization's behalf. Where a banking organization is acting as agent for a customer in a transaction involving the lending or sale of securities that is collateralized by cash delivered to the banking organization, the transaction is deemed to be collateralized by cash on deposit in the banking organization for purposes of determining the appropriate risk-weight category, provided that any indemnification is limited to no more than the difference between the market value of the securities and the cash collateral received and any reinvestment risk associated with that cash collateral is borne by the customer.

* * * * *

By order of the Board of Governors of the Federal Reserve System, October 21, 1997.

William W. Wiles,

Secretary of the Board.

Federal Deposit Insurance Corporation

12 CFR CHAPTER III

Authority and Issuance

For the reasons set forth in the joint preamble, part 325 of chapter III of title 12 of the Code of Federal Regulations is proposed to be amended as follows:

PART 325—CAPITAL MAINTENANCE

1. The authority citation for part 325 continues to read as follows:

Authority: 12 U.S.C. 1815(a), 1815(b), 1816, 1818(a), 1818(b), 1818(c), 1818(t), 1819(Tenth), 1828(c), 1828(d), 1828(i), 1828(n), 1828(o), 1831o, 3907, 3909, 4808; Pub. L. 102–233, 105 Stat. 1761, 1789, 1790 (12 U.S.C. 1831n note); Pub. L. 102-242, 105 Stat. 2236, 2355, 2386 (12 U.S.C. 1828 note).

2. In appendix A to part 325, section II.B. is amended by revising paragraph 5. to read as follows:

Appendix A to Part 325—Statement of Policy on Risk-Based Capital

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II. Procedures for Computing Risk-Weighted Assets

* * * * *

B. * * *

5. *Recourse obligations, direct credit substitutes, and asset-and mortgage-backed securities.* Direct credit substitutes, assets transferred with recourse, and securities issued in connection with asset securitizations are treated as described in paragraphs B.5.(b) through (e) of this section.

(a) *Definitions.* (i) *Direct credit substitute* means an arrangement in which a bank assumes, in form or in substance, any risk of credit loss directly or indirectly associated with a third-party asset or other financial claim, that exceeds the bank's *pro rata* share of the asset or claim. If the bank has no claim on the asset, then the assumption of any risk of loss is a direct credit substitute. Direct credit substitutes include, but are not limited to:

(1) Financial guarantee-type standby letters of credit that support financial claims on the account party;

(2) Guarantees, surety arrangements, and irrevocable guarantee-type instruments backing financial claims such as outstanding securities, loans, or other financial liabilities, or that back off-balance-sheet items against which risk-based capital must be maintained;

(3) Purchased subordinated interests or securities that absorb more than their pro rata share of losses from the underlying assets;

(4) Loans or lines of credit that provide credit enhancement for the financial obligations of an account party; and

(5) Purchased loan servicing assets if the servicer is responsible for credit losses associated with the loans being serviced (other than mortgage servicer cash advances as defined in paragraph B.5.(a)(iii) of this section), or if the servicer makes or assumes representations and warranties on the loans other than standard representations and warranties as defined in paragraph B.5.(a)(vii) of this section.

(ii) *Financial guarantee-type standby letter of credit* means any letter of credit or similar arrangement, however named or described, that represents an irrevocable obligation to the beneficiary on the part of the issuer:

(1) To repay money borrowed by, advanced to, or for the account of, the account party; or

(2) To make payment on account of any indebtedness undertaken by the account party in the event that the account party fails to fulfill its obligation to the beneficiary.

(iii) *Mortgage servicer cash advance* means funds that a residential mortgage loan servicer advances to ensure an uninterrupted flow of payments or the timely collection of residential mortgage loans, including disbursements made to cover foreclosure costs or other expenses arising from a mortgage loan to facilitate its timely collection. A servicer cash advance is not a recourse obligation or a direct credit substitute if the mortgage servicer is entitled to full reimbursement or, for any one residential mortgage loan, nonreimbursable advances are contractually limited to an insignificant amount of the outstanding principal on that loan.

(iv) *Nationally recognized statistical rating organization* means an entity recognized by the Division of Market Regulation of the Securities and Exchange Commission as a nationally recognized statistical rating organization for various purposes, including the Commission's uniform net capital requirements for brokers or dealers (17 CFR 240.15c3–1(c)(2)(vi)(E), (F), and (H)).

(v) *Rated* means a recourse obligation, direct credit substitute, or asset-or mortgage-backed security that is retained, assumed, or issued in connection with an asset securitization and that has received a credit rating from a nationally recognized statistical rating organization. A position is rated investment grade if it has received a credit rating that falls within one of the four highest rating categories used by the organization (e.g., at least "BBB" or its equivalent). A position is rated in the highest investment grade if it has received a credit rating that falls within the highest rating category used by the organization.

(vi) *Recourse* means an arrangement in which a bank retains, in form or in substance, any risk of credit loss directly or indirectly associated with a transferred asset that exceeds a pro rata share of the bank's claim on the asset. If a bank has no claim on a transferred asset, then the retention of any risk of loss is recourse. A recourse obligation typically arises when an institution transfers assets and retains an obligation to repurchase the assets or absorb losses due to a default of principal or interest or any other deficiency in the performance of the underlying obligor or some other party. Recourse may exist implicitly where a bank provides credit enhancement beyond any contractual obligation to support assets it has sold. Recourse obligations include, but are not limited to:

(1) Representations and warranties on the transferred assets other than standard representations and warranties as defined in paragraph B.5.(a)(vii) of this section;

(2) Retained loan servicing assets if the servicer is responsible for losses associated with the loans being serviced other than mortgage servicer cash advances as defined in paragraph B.5.(a)(iii) of this section;

(3) Retained subordinated interests or securities that absorb more than their *pro rata* share of losses from the underlying assets;

(4) Assets sold under an agreement to repurchase; and

(5) Loan strips sold without direct recourse where the maturity of the transferred loan that is drawn is shorter than the maturity of the commitment.

(vii) *Standard representations and warranties* means contractual assurances regarding the nature, quality, and condition of assets that a bank extends when it transfers

[48] Forward forward deposits accepted are treated as interest rate contracts.

assets (including loan servicing assets) or assumes when it purchases loan servicing assets, but only to the extent that the assurances:

(*1*) Refer to facts that the seller or servicer can verify, and has verified with reasonable due diligence, prior to the time that assets are transferred (or servicing assets are acquired);

(*2*) Refer to a condition that is within the control of the seller or servicer; or

(*3*) Provide for the return of assets in the event of fraud or documentation deficiencies.

(*viii) Traded position* means a recourse obligation, direct credit substitute, or asset-or mortgage-backed security that is retained, assumed, or issued in connection with an asset securitization and that is rated with a reasonable expectation that, in the near future:

(*1*) The position would be sold to investors relying on the rating; or

(*2*) A third party would, in reliance on the rating, enter into a transaction such as a purchase, loan, or repurchase agreement involving the position.

(b) *Amount of position to be included in risk-weighted assets.* (i) *General rule.* The credit equivalent amount for a recourse obligation or direct credit substitute is the full amount of the credit enhanced assets from which risk of credit loss is directly or indirectly retained or assumed. This credit equivalent amount is assigned to the risk weight appropriate to the obligor or, if relevant, the guarantor or nature of any collateral. For purposes of this appendix A, the full amount of the credit enhanced assets from which risk of credit loss is directly or indirectly retained or assumed means for:

(*1*) A financial guarantee-type standby letter of credit, surety arrangement, guarantee, or irrevocable guarantee-type instruments, the full amount of the assets that the direct credit substitute fully or partially supports;

(*2*) A subordinated interest or security, the amount of the subordinated interest or security plus all more senior interests or securities;

(*3*) Mortgage servicing assets that are recourse obligations or direct credit substitutes, the outstanding amount of the loans serviced;

(*4*) Representations and warranties (other than standard representations and warranties), the amount of the assets subject to the representations or warranties;

(*5*) Loans or lines of credit that provide credit enhancement for the financial obligations of an account party, the full amount of the enhanced financial obligations;

(*6*) Loans strips, the amount of the loans; and

(*7*) For assets sold with recourse, the amount of assets from which risk of loss is directly or indirectly retained, less any applicable recourse liability account established in accordance with generally accepted accounting principles.

For example, a bank that extends a partial direct credit substitute, e.g., a financial guarantee-type standby letter of credit that absorbs the first 10 percent of loss on a transaction, must maintain capital against the full amount of the assets being supported. Furthermore, for a recourse obligation or a direct credit substitute that is an on-balance sheet asset, e.g., a retained or purchased subordinated security, a bank must maintain capital against the amount of the on-balance sheet asset plus the full amount of the assets not on the bank's balance sheet that are being supported, *i.e.*, all more senior positions.

(ii) *Determining the credit risk weight of investment grade recourse obligations, direct credit substitutes, and asset- and mortgage-backed securities.* Notwithstanding paragraph B.5.(b)(i) of this section, a traded position is eligible for the following risk-based capital treatment. A recourse obligation or direct credit substitute that is not a traded position also is eligible for the following treatment if it has been rated at least investment grade by two nationally recognized statistical rating organizations, the ratings are publicly available, the ratings are based on the same criteria used to rate securities sold to the public, and the recourse obligation or direct credit substitute provides credit enhancement to a securitization in which there is at least one traded position.

(*1*) *Highest investment grade.* The face amount of a recourse obligation, direct credit substitute, or an asset- or mortgage-backed security that is rated in the highest investment grade category is assigned to the 20 percent risk category.

(*2*) *Other investment grade.* [Option 1—Face Value Treatment] The face amount of a recourse obligation, direct credit substitute, or an asset- or mortgage-backed security that is rated investment grade (but not in the highest investment grade category) is assigned to the 100 percent risk category.

[Option 2—Modified Gross-Up] For a recourse obligation, direct credit substitute, or an asset- or mortgage-backed security that is rated investment grade (but not in the highest investment grade category), the full amount of the credit enhanced assets from which risk of credit loss is directly or indirectly retained or assumed by the bank is assigned to the 50 percent risk category, regardless of the face amount of the bank's risk position. For a senior asset-or mortgage-backed security which provides no credit enhancement, this means that the face amount of the security is assigned to the 50 percent risk category.

(iii) *Risk participations and syndications in direct credit substitutes. (1)* In the case of a direct credit substitute in which a risk participation [14] has been conveyed, the full amount of the credit enhanced assets from which risk of credit loss is directly or indirectly retained or assumed, in whole or in part, by the direct credit substitute is converted to a credit equivalent amount at 100 percent. However, the *pro rata* share of the credit equivalent amount that has been conveyed through a risk participation is assigned to whichever risk category is lower: The risk category appropriate to the obligor, after considering any relevant guarantees or collateral, or the risk category appropriate to the institution acquiring the participation.[15] Any remainder of the credit equivalent amount is assigned to the risk category appropriate to the obligor, guarantor, or collateral. For example, the *pro rata* share of the full amount of the assets supported, in whole or in part, by a direct credit substitute conveyed as a risk participation to a U.S. domestic depository institution or foreign bank is assigned to the 20 percent risk category.[16]

(*2*) The capital treatment for risk participations, either conveyed or acquired, and syndications in direct credit substitutes that are associated with an asset securitization and are rated at least investment grade is set forth in paragraph B.5.(b)(ii) of this section. A lower risk category may be applicable depending on the obligor or nature of the institution acquiring the participation.

(*3*) In the case of a direct credit substitute in which a risk participation has been acquired, the acquiring bank's percentage share of the direct credit substitute is multiplied by the full amount of the credit enhanced assets from which risk of credit loss is directly or indirectly retained or assumed, in whole or in part, by the direct credit substitute and is converted to a credit equivalent amount at 100 percent. The credit equivalent amount of an acquisition of a risk participation in a direct credit substitute is assigned to the risk category appropriate to the account party obligor or, if relevant, the nature of the collateral or guarantees.

(*4*) In the case of a direct credit substitute that takes the form of a syndication where each bank is obligated only for its *pro rata* share of the risk and there is no recourse to the originating bank, each bank will only include in its risk-based capital calculation only its *pro rata* share of the credit enhanced assets from which risk of credit loss is directly or indirectly retained or assumed, in whole or in part, by the direct credit substitute.[17]

(c) *Limitations on risk-based capital requirements.* (i) *Low-level recourse.* If the maximum contractual liability or exposure to loss retained or assumed by a bank in connection with a recourse

[14] That is, a participation in which the originating bank remains liable to the beneficiary for the full amount of the direct credit substitute if the party that has acquired the participation fails to pay when the instrument is drawn.

[15] A risk participation in a bankers acceptance conveyed to another institution is also assigned to the risk category appropriate to the institution acquiring the participation or, if relevant, the guarantor or nature of the collateral.

[16] A risk participation with a remaining maturity of over one year that is conveyed to a non-OECD bank is to be assigned to the 100 percent risk category, unless a lower risk category is appropriate to the obligor, guarantor, or collateral.

[17] For example, if a bank has a 10 percent share of a $10 syndicated direct credit substitute that provides credit support to a $100 loan, then the bank's $1 *pro rata* share in the enhancement means that a $10 *pro rata* share of the loan is included in risk-weighted assets.

obligation or a direct credit substitute is less than the amount of capital which would be held under the applicable risk-based capital requirement for the enhanced assets, the bank need only hold capital equal to the maximum contractual liability or exposure to loss, less any recourse liability account established in accordance with generally accepted accounting principles. This exception does not apply to assets sold with implicit recourse.

(ii) *Mortgage-related securities or participation certificates retained in a mortgage loan swap.* If a bank holds a mortgage-related security or a participation certificate as a result of a mortgage loan swap with recourse, capital is required to support the recourse obligation plus the percentage of the mortgage-related security or participation certificate that is not covered by the recourse obligation. The total amount of capital required for the on-balance sheet asset and the recourse obligation, however, is limited to the capital requirement for the underlying loans, calculated as if the bank continued to hold these loans as an on-balance sheet asset.

(iii) *Related on-balance sheet assets.* If a recourse obligation or direct credit substitute subject to section II.B.5. of this appendix A also appears as an on-balance sheet asset, the credit equivalent amount of the recourse obligation or direct credit substitute is determined in accordance with paragraph B.5.(b) of this section and the balance sheet asset is not separately included in a bank's risk-weighted assets, except in the case of mortgage servicing assets and similar arrangements with embedded recourse obligations or direct credit substitutes. In such cases, both the on-balance sheet assets and the related recourse obligations and direct credit substitutes are incorporated into the risk-based capital calculation.

(d) *Privately-issued mortgage-backed securities.* Generally, a privately-issued mortgage-backed security meeting certain criteria, set forth in the accompanying footnote, [18] is essentially treated as an indirect holding of the underlying assets, and assigned to the same risk category as the underlying assets, but in no case to the zero percent risk category. However, any class of a privately-issued mortgage-backed security whose structure does not qualify it to be regarded as an indirect holding of the underlying assets or that can absorb more than its *pro rata* share of loss without the whole issue being in default (for example, a so-called subordinated class) is treated in accordance with paragraph B.5.(b) of this section. Furthermore, all privately-issued stripped mortgage-backed securities, including interest-only strips (IOs), principal-only strips (POs), and similar instruments, are assigned to the 100 percent risk weight category, regardless of the issuer or guarantor.

(e) *Other stripped mortgage-backed securities.* All other stripped mortgage-backed securities, including interest-only strips (IOs), principal-only strips (POs), and similar instruments, are assigned to the 100 percent risk weight category, regardless of the issuer or guarantor.

* * * * *

3. In appendix A to part 325, section II.C., *Category 1* through *Category 3*, footnotes 15 through 32 are redesignated as footnotes 19 through 36, the four undesignated paragraphs under *Category 3—50 Percent Risk Weight* are designated as paragraphs a. through d., respectively, and newly redesignated footnote 33 is revised to read as follows:

* * * * *

II. * * *

C. * * *

Category 3—50 Percent Risk Weight. * * *

b. * * * [33] * * *

* * * * *

4. In appendix A to part 325, section II.C., *Category 4—100 Percent Risk Weight* is revised to read as follows:

* * * * *

II. * * *

C. * * *

Category 4—100 Percent Risk Weight. a. All assets not included in the categories above are assigned to this category, which comprises standard risk assets. The bulk of the assets typically found in a loan portfolio would be assigned to the 100 percent category.

b. This category includes:

(1) Long-term claims on, and the portions of long-term claims that are guaranteed by, non-OECD banks, and all claims on non-OECD central governments that entail some degree of transfer risk; [37]

(2) All claims on foreign and domestic private-sector obligors not included in the categories above (including loans to nondepository financial institutions and bank holding companies);

(3) Claims on commercial firms owned by the public sector;

(4) Customer liabilities to the bank on acceptances outstanding involving standard risk claims; [38]

(5) Investments in fixed assets, premises, and other real estate owned;

(6) Common and preferred stock of corporations, including stock acquired for debts previously contracted;

(7) Commercial and consumer loans (except (a) those assigned to lower risk categories due to recognized guarantees or collateral and (b) loans secured by residential property that qualify for a lower risk weight);

(8) All stripped mortgage-backed securities and similar instruments;

(9) Industrial-development bonds and similar obligations issued under the auspices of state or political subdivisions of the OECD-based group of countries for the benefit of a private party or enterprise where that party or enterprise, not the government entity, is obligated to pay the principal and interest; and

(10) All obligations of states or political subdivisions of countries that do not belong to the OECD-based group of countries.

c. The following assets also are assigned a risk weight of 100 percent if they have not been deducted from capital: investments in unconsolidated subsidiaries, joint ventures, or associated companies; instruments that qualify as capital issued by other banking organizations; and servicing assets and intangible assets.

* * * * *

5. In appendix A to part 325, section II.D. is amended by redesignating footnotes 38 through 42 as footnotes 41 through 45 and by revising the undesignated introductory

[18] A privately-issued mortgage-backed security may be treated as an indirect holding of the underlying assets provided that: (1) The underlying assets are held by an independent trustee and the trustee has a first priority, perfected security interest in the underlying assets on behalf of the holders of the security; (2) either the holder of the security has an undivided *pro rata* ownership interest in the underlying mortgage assets or the trust or single purpose entity (or conduit) that issues the security has no liabilities unrelated to the issued securities; (3) the security is structured such that the cash flow from the underlying assets in all cases fully meets the cash flow requirements of the security without undue reliance on any reinvestment income; and (4) there is no material reinvestment risk associated with any funds awaiting distribution to the holders of the security. In addition, if the underlying assets of a mortgage-backed security are composed of more than one type of asset, the entire mortgage-backed security is generally assigned to the category appropriate to the highest risk-weighted asset underlying the issue.

[33] The types of loans that qualify as loans secured by multifamily residential properties are listed in the instructions for preparation of the Consolidated Reports of Condition and Income. In addition, from the standpoint of the selling bank, when a multifamily residential property loan is sold subject to a *pro rata* loss sharing arrangement which provides for the purchaser of the loan to share in any loss incurred on the loan on a pro rata basis with the selling bank, that portion of the loan is not subject to the risk-based capital standards. In connection with sales of multifamily residential property loans in which the purchaser of the loan shares in any loss incurred on the loan with the selling institution on other than a *pro rata* basis, the selling bank must treat these other loss sharing arrangements in accordance with section II.B.5. of this appendix A.

[37] Such assets include all nonlocal-currency claims on, and the portions of claims that are guaranteed by, non-OECD central governments and those portions of local-currency claims on, or guaranteed by, non-OECD central governments that exceed the local-currency liabilities held by subsidiary depository institutions.

[38] Customer liabilities on acceptances outstanding involving nonstandard risk claims, such as claims on U.S. depository institutions, are assigned to the risk category appropriate to the identity of the obligor or, if relevant, the nature of the collateral or guarantees backing the claims. Portions of acceptances conveyed as risk participations to U.S. depository institutions or foreign banks are assigned to the 20 percent risk category appropriate to short-term claims guaranteed by U.S. depository institutions and foreign banks.

paragraph of section II.D. and section II.D.1. to read as follows:

* * * * *

II. * * *

D. * * *

The face amount of an off-balance sheet item is generally incorporated into risk-weighted assets in two steps. The face amount is first multiplied by a credit conversion factor, except for direct credit substitutes and recourse obligations as discussed in section II.D.1. of this appendix A. The resultant credit equivalent amount is assigned to the appropriate risk category according to the obligor or, if relevant, the guarantor or the nature of the collateral.[39]

1. *Items With a 100 Percent Conversion Factor.* a. Except as otherwise provided in section II.B.5. of this appendix A, the full amount of an asset or transaction supported, in whole or in part, by a direct credit substitute or a recourse obligation. Direct credit substitutes and recourse obligations are defined in section II.B.5. of this appendix A.

b. Sale and repurchase agreements, if not already included on the balance sheet, and forward agreements. Forward agreements are legally binding contractual obligations to purchase assets with drawdown which is certain at a specified future date. These obligations include forward purchases, forward forward deposits placed,[40] and partly-paid shares and securities, but they do not include commitments to make residential mortgage loans or forward foreign exchange contracts.

c. Securities lent by a bank are treated in one of two ways, depending on whether the lender is exposed to risk of loss. If a bank, as agent for a customer, lends the customer's securities and does not indemnify the customer against loss, then the securities lending transaction is excluded from the risk-based capital calculation. On the other hand, if a bank lends its own securities or, acting as agent for a customer, lends the customer's securities and indemnifies the customer against loss, the transaction is converted at 100 percent and assigned to the risk weight category appropriate to the obligor or, if applicable, to any collateral delivered to the lending bank or the independent custodian acting on the lending bank's behalf. When a bank is acting as a customer's agent in a transaction involving the loan or sale of the customer's securities that is collateralized by cash delivered to the lending bank, the transaction is deemed to be collateralized by cash on deposit with the bank for purposes of determining the appropriate risk-weight category, provided that any indemnification is limited to no more than the difference between the market value of the securities lent or sold and the cash collateral received, and any reinvestment risk associated with the cash collateral is borne by the customer.

* * * * *

[39] The sufficiency of collateral and guarantees for off-balance-sheet items is determined by the market value of the collateral of the amount of the guarantee in relation to the face amount of the item, except for derivative contracts, for which this determination is generally made in relation to the credit equivalent amount. Collateral and guarantees are subject to the same provisions noted under section II.B. of this appendix A.

[40] Forward forward deposits accepted are treated as interest rate contracts.

6. In appendix A to part 325, Table II—Summary of Risk Weights and Risk Categories is amended under Category 2—20 Percent Risk Weight by adding a new paragraph (13) to read as follows:

* * * * *

Table II—Summary of Risk Weights and Risk Categories

* * * * *

Category 2—20 Percent Risk Weight

* * * * *

(13) The face amount of a recourse obligation, direct credit substitute, or asset- or mortgage-backed security that is rated in the highest investment grade category.

* * * * *

7. In appendix A to part 325, Table II—Summary of Risk Weights and Risk Categories is amended under Category 3—50 Percent Risk Weight by adding a new paragraph (6) to read as follows:

* * * * *

Table II—Summary of Risk Weights and Risk Categories

* * * * *

Category 3—50 Percent Risk Weight

* * * * *

[Option 2—Modified Gross-Up] (6) The full amount of the credit enhanced assets from which risk of credit loss is directly or indirectly retained or assumed through a recourse obligation, direct credit substitute, or asset- or mortgage-backed security that is rated investment grade (but below the highest investment grade category).

* * * * *

8. In appendix A to part 325, Table III—Credit Conversion Factors for Off-Balance Sheet Items, the item "100 Percent Conversion Factor" is revised and a new item "Credit Conversion for Recourse Obligations and Direct Credit Substitutes" is added after the item "Zero Percent Conversion Factor" to read as follows:

* * * * *

Table III—Credit Conversion Factors for Off-Balance Sheet Items 100 Percent Conversion Factor

100 Percent Conversion Factor

(1) Sale and repurchase agreements, if not already included on the balance sheet.

(2) Forward agreements representing contractual obligations to purchase assets, including financing facilities, with drawdown *certain* at a specified future date.

(3) Securities lent, if the lending bank is exposed to risk of loss.

* * * * *

Credit Conversion for Recourse Obligations and Direct Credit Substitutes

The credit equivalent amount for an off-balance sheet recourse obligation or direct credit substitute:

(1) That is not rated at least investment grade is the full amount of the credit enhanced assets from which risk of loss is directly or indirectly retained or assumed, subject to the low-level recourse rule.

(2) That is rated in the highest investment grade category is its face amount.

(3) That is rated investment grade, but below the highest investment grade category, is [Option 1—Face Value Treatment] its face amount.

[Option 2—Modified Gross-Up] the full amount of the credit enhanced assets from which risk of credit loss is directly or indirectly retained or assumed.

* * * * *

Dated at Washington, D.C., this 16th day of September, 1997. Federal Deposit Insurance Corporation.

By order of the Board of Directors.

Robert E. Feldman,

Executive Secretary.

Office of Thrift Supervision

12 CFR CHAPTER V

Authority and Issuance

For the reasons set out in the preamble, part 567 of chapter V of title 12 of the Code of Federal Regulations is proposed to be amended as follows:

PART 567—CAPITAL

1. The authority citation for part 567 continues to read as follows:

Authority: 12 U.S.C. 1462, 1462a, 1463, 1464, 1467a, 1828(note).

2. Section 567.1 is amended by removing and reserving paragraph (f), by removing in paragraph (i)(2) including text the phrase "§ 567.6(a)(vi)" and adding in lieu thereof the phrase "§ 567.6(a)(1)(vi)" and by revising paragraph (kk), to read as follows:

§ 567.1 Definitions.

* * * * *

(kk) *Standby letter of credit.* (1) *Financial guarantee-type standby letter of credit* means any letter of credit or similar arrangement, however named or described, that represents an irrevocable obligation to the beneficiary on the part of the issuer:

(i) To repay money borrowed by, advanced to, or for the account of an account party; or

(ii) To make payment on account of any indebtedness undertaken by an account party, in the event that the account party fails to fulfill its obligation to the beneficiary.

(2) *Performance-based standby letter of credit* means any letter of credit, or similar arrangement, however named or described, which represents an irrevocable obligation to the beneficiary on the part of the issuer to make payment on account of any default by a

third party in the performance of a nonfinancial or commercial obligation.

* * * * *

3. Section 567.6 is amended by revising paragraphs (a) heading and introductory text, (a)(1) introductory text, and (a)(2) introductory text, removing and reserving paragraphs (a)(2)(i)(A) and (C), revising paragraphs (a)(2)(i)(B) and (a)(3), and adding paragraph (b) to read as follows:

§ 567.6 Risk-based capital credit risk-weight categories.

(a) *Risk-weighted assets.* Risk-weighted assets equal risk-weighted on-balance sheet assets (as computed under paragraph (a)(1) of this section), plus risk-weighted off-balance sheet items (as computed under paragraph (a)(2) of this section), plus risk-weighted recourse obligations, direct credit substitutes, and asset-and mortgage-backed securities (as computed under paragraph (a)(3) of this section). Assets not included for purposes of calculating capital pursuant to § 567.5 are not included in calculating risk-weighted assets.

(1) *On-balance sheet assets.* Except as provided in paragraph (a)(3) of this section, risk-weighted on-balance sheet assets are computed by multiplying the on-balance sheet asset amount times the appropriate risk weight categories. The risk weight categories for on-balance sheet assets are:

* * * * *

(2) *Off-balance sheet activities.* Except as provided in paragraph (a)(3) of this section, risk-weights for off-balance sheet items are determined by the following two-step process. First, the face amount of the off-balance sheet item must be multiplied by the appropriate credit conversion factor listed in this paragraph (a)(2). This calculation translates the face amount of an off-balance sheet exposure into an on-balance sheet credit-equivalent amount. Second, the credit-equivalent amount must be assigned to the appropriate risk weight category using the criteria regarding obligors, guarantors, and collateral listed in paragraph (a)(1) of this section, *provided* that the maximum risk weight assigned to the credit-equivalent amount of an interest-rate or exchange-rate contract is 50 percent. The following are the credit conversion factors and the off-balance sheet items to which they apply:

(i) * * *

(B) Risk participations purchased in bank acceptances;

* * * * *

(3) *Recourse obligations, direct credit substitutes, and asset- and mortgage-backed securities*—(i) *Risk-weighted asset amount.* Except as otherwise provided in this paragraph (a)(3), to calculate the risk-weighted asset amount for a recourse obligation or a direct credit substitute, multiply the amount of assets from which risk of credit loss is directly or indirectly retained or assumed, by the appropriate risk weight using the criteria regarding obligors, guarantors, and collateral listed in paragraph (a)(1) of this section. For purposes of this paragraph (a)(3), the amount of assets from which risk of credit loss is directly or indirectly retained or assumed means:

(A) For a financial guarantee-type standby letter of credit, surety arrangement, guarantee, or irrevocable guarantee-type instrument, the amount of assets that the direct credit substitute fully or partially supports;

(B) For a subordinated interest or security, the amount of the subordinated interest or security, plus all more senior interests or securities;

(C) For mortgage servicing rights that are recourse obligations or direct credit substitutes, the outstanding amount of the loans serviced;

(D) For representations and warranties (other than standard representations and warranties), the amount of the assets subject to the representations or warranties;

(E) For loans on lines of credit that provide credit enhancement for the financial obligations of the financial obligations of an account party, the amount of the enhanced financial obligations;

(F) For loans strips, the amount of the loans; and

(G) For assets sold with recourse, the amount of assets from which risk of credit loss is directly or indirectly retained, less any applicable recourse liability account established in accordance with generally accepted accounting principles. Other types of recourse obligations or direct credit substitutes should be treated in accordance with the principles contained in this paragraph (a)(3)(i).

(ii) *Investment grade recourse obligations, direct credit substitutes, and asset-and mortgage-backed securities.*—(A) *Eligibility.* A traded position in an asset-or mortgage-backed securitization is eligible for the treatment described in this paragraph (a)(3)(ii), if it has been rated investment grade by a nationally recognized statistical rating organization. A recourse obligation or direct credit substitute that is not a traded position is eligible for the treatment described in this paragraph (a)(3)(ii) if it has been rated investment grade by two nationally recognized statistical rating organizations, the ratings are publicly available, the ratings are based on the same criteria used to rate securities sold to the public, and the recourse obligation or direct credit substitute provide credit enhancement to a securitization in which at least one position is traded.

(B) *Highest investment grade.* To calculate the risk-weighted asset amount for a recourse obligation, direct credit substitute, or asset-or mortgage-backed security that is rated in the highest investment grade category, multiply the face amount of the position by a risk weight of 20 percent.

(C) *Other investment grade.* [Option I—Face Value Treatment] To calculate the risk-weighted asset amount for a recourse obligation, direct credit substitute, or asset-or mortgage-backed security that is rated investment grade, multiply the face amount of the position by a risk weight of 100 percent.

[Option II—Modified Gross-Up Treatment] To calculate the risk-weighted asset amount for a recourse obligation, direct credit substitute, or asset-or mortgage backed security that is rated investment grade, multiply the amount of assets from which risk of credit loss is directly or indirectly retained or assumed (*see* paragraphs (a)(3)(i)(A) through (F) of this section), by a risk weight of 50 percent.

(iii) *Participations.* The risk-weighted asset amount for a participation interest in a recourse obligation or direct credit substitute is calculated as follows:

(A) Determine the risk-weighted asset amount for the recourse obligation or direct credit substitute as if the savings association held all of the interests in the participation;

(B) Multiply this amount by the percentage of the savings association's participation interest; and

(C) If the savings association is exposed to more than its *pro rata* share of the risk of credit loss on the recourse obligation or direct credit substitute (*e.g.*, the savings association remains secondarily liable on participations held by others), add to the amount computed under paragraph (a)(3)(iii)(B) of this section, an amount computed as follows: Multiply the amount of the recourse obligation or direct credit substitute by the percentage of the recourse obligation or direct credit substitute held by others and then multiply the result by the lesser of the risk weight appropriate for the holders of those interests or the risk weight appropriate to the recourse obligation or direct credit substitute.

(iv) *Alternative capital computation for small business obligations.*

(A) *Definitions.* For the purposes of this paragraph (a)(3)(iv):

(*1*) *Qualified savings association* means a savings association that:

(*i*) Is well capitalized as defined in § 565.4 of this chapter without applying the capital treatment described in paragraph (a)(3)(iv)(B) of this section; or

(*ii*) Is adequately capitalized as defined in § 565.4 of this chapter without applying the capital treatment described in paragraph (a)(3)(iv)(B) of this section and has received written permission from the OTS to apply that capital calculation.

(*2*) *Small business* means a business that meets the criteria for a small business concern established by the Small Business Administration in 12 CFR part 121 pursuant to 15 U.S.C. 632.

(B) *Capital requirement.* With respect to a transfer of a small business loan or lease of personal property with recourse that is a sale under generally accepted accounting principles, a qualified savings association may elect to include only the amount of its retained recourse in its risk-weighted assets for the purposes of this paragraph (a)(3). To qualify for this election, the savings association must establish and maintain a reserve under generally accepted accounting principles sufficient to meet the reasonable estimated liability of the savings association under the recourse obligation.

(C) *Aggregate amount of recourse.* The total outstanding amount of recourse retained by a qualified savings association with respect to transfers of small business loans and leases of personal property and included in the risk-weighted assets of the savings association as described in this paragraph (a)(3), may not exceed 15 percent of the association's total capital computed under § 567.5(c)(4).

(D) *Savings association that ceases to be a qualified savings association or that exceeds aggregate limits.* If a savings association ceases to be a qualified savings association or exceeds the aggregate limit described in paragraph (a)(3)(iv)(C) of this section, the savings association may continue to apply the capital treatment described in paragraph (a)(3)(iv)(B) of this section to transfers of small business loans and leases of personal property that occurred when the association was a qualified savings association and did not exceed the limit.

(E) *Prompt corrective action not affected.* (*1*) A savings association shall compute its capital without regard to this paragraph (a)(3)(iv) of this section for purposes of prompt corrective action (12 U.S.C. 1831o), unless the savings association is adequately or well capitalized without applying the capital treatment described in this paragraph (a)(3)(iv) and would be well capitalized after applying that capital treatment.

(*2*) A savings association shall compute its capital requirement without regard to this paragraph (a)(3)(iv) for the purposes of applying 12 U.S.C. 1381o(g), regardless of the association's capital level.

(v) *Limitations on risk-based capital requirements.*—(A) *Low level recourse.* (*1*) If the maximum contractual liability or exposure to credit loss retained or assumed by a savings association in connection with a recourse obligation or a direct credit substitute is less than the effective risk-based capital requirement for the enhanced asset, the risk based capital requirement is limited to the maximum contractual liability or exposure to credit loss. For assets sold with recourse, the amount of capital required to support the recourse obligation is limited to the maximum contractual liability or exposure to credit loss less the amount of the recourse liability account established in accordance with generally accepted accounting principles.

(*2*) The low level recourse limitation does not apply to assets sold with implicit recourse.

(B) *Mortgage-related securities or participation certificates retained in a mortgage loan swap.* If a savings association holds a mortgage-related security or a participation certificate as a result of a mortgage loan swap with recourse, capital is required to support the recourse obligation (including consideration of any low level recourse limitation described at paragraph (a)(3)(v)(A) of this section), plus the percentage of the mortgage-related security or participation certificate that is not protected against risk of loss by the recourse obligation. The total amount of capital required for the on-balance sheet asset and the recourse obligation, however, is limited to the capital requirement for the underlying loans, calculated as if the savings association continued to hold these loans as an on-balance sheet asset.

(C) *Related on-balance sheet assets.* To the extent that an asset is included in the calculation of the risk-based capital requirement under this paragraph (a)(3), and may also be included as an on-balance sheet asset under paragraph (a)(1) of this section, the asset shall be risk-weighted only under this paragraph (a)(3) except:

(*1*) Mortgage servicing assets and similar arrangements with embedded recourse obligations or direct credit substitutes are risk weighted as on-balance sheet assets under paragraph (a)(1) of this section, and the related recourse obligations and direct credit substitutes are risk-weighted under this paragraph (a)(3); and

(*2*) Purchased subordinated interests that are high quality mortgage-related securities are not subject to risk weighting under this paragraph (a)(3). Rather, the face values of these assets are risk-weighted as on-balance sheet assets under paragraph (a)(1)(ii)(H) of this section.

(vi) *Obligations of subsidiaries.* If a savings association retains a recourse obligation or assumes a direct credit substitute on the obligation of a subsidiary that is not an includable subsidiary, and the recourse obligation or direct credit substitute is an equity or debt investment in that subsidiary under generally accepted accounting principles, the face amount of the recourse obligation or direct credit substitute is deducted for capital under §§ 567.5(a)(2) and 567.9(c). All other recourse obligations and direct credit substitutes retained or assumed by a savings association on the obligations of an entity in which the savings association has an equity investment are risk-weighted in accordance with paragraphs (a)(3)(i) through (v) of this section.

(b) *Definitions.* For the purposes of this section:

(1) *Direct credit substitute* means an arrangement in which a savings association assumes, in form or in substance, any risk of credit loss directly or indirectly associated with a third party asset or other financial claim, that exceeds the savings association's *pro rata* share of the asset or claim. If a savings association has no claim on an asset, then the assumption of any risk of credit loss is a direct credit substitute. Direct credit substitutes include, but are not limited to:

(i) Financial guarantee-type standby letters of credit that support financial claims on the account party;

(ii) Guarantees, surety arrangements, and irrevocable guarantee-type instruments backing financial claims;

(iii) Purchased subordinated interests or securities that absorb more than their *pro rata* share of losses from the underlying assets;

(iv) Loans or lines of credit that provide credit enhancement for the financial obligations of an account party; and

(v) Purchased loan servicing assets if the servicer is responsible for credit losses associated with the loans being serviced (other than a servicer cash advance as defined in this section), or if the servicer makes or assumes representations and warranties on the loans other than standard representation and warranties as defined in this section.

(2) *Rated* means, with respect to an instrument or obligation, that the instrument or obligation has received a credit rating from a nationally-recognized statistical rating organization. An instrument or obligation is rated investment grade if it has received a credit rating that falls within one of the four highest rating categories used by the organization. An instrument or obligation is rated in the highest investment grade if it has received a credit rating that falls within the highest rating category used by the organization.

(3) *Recourse* means the retention, in form or in substance, of any risk of credit loss directly or indirectly associated with a transferred asset, that exceeds a *pro rata* share of the savings association's claim on the asset. If a savings association has no claim on a transferred asset, then the retention of any risk of credit loss is recourse. A recourse obligation typically arises when an institution transfers its assets and retains an obligation to repurchase the assets, or to absorb losses due to a default of principal or interest or any other deficiency in the performance of the underlying obligor or some other party. Recourse may exist implicitly where a savings association provides credit enhancement beyond any contractual obligation to support the assets it has sold. Recourse obligations include, but are not limited to:

(i) Representations and warranties on the transferred assets other than standard representations and warranties as defined in this section;

(ii) Retained loan servicing assets if the servicer is responsible for losses associated with the loans serviced (other than a servicer cash advance as defined in this section);

(iii) Retained subordinated interests or securities that absorb more than their *pro rata* share of losses from the underlying assets;

(iv) Assets sold under an agreement to repurchase; and

(v) Loan strips sold without direct recourse where the maturity of the transferred loan is shorter than the maturity of the commitment.

(4) *Servicer cash advance* means funds that a residential mortgage loan servicer advances to ensure an uninterrupted flow of payments or the timely collection of residential mortgage loans, including disbursements made to cover foreclosure costs or other expenses arising from a mortgage loan to facilitate its timely collection. A servicer cash advance is not a recourse obligation or a direct credit substitute if:

(i) The mortgage servicer is entitled to full reimbursement; or

(ii) For any one residential mortgage loan, nonreimbursed advances are contractually limited to an insignificant amount of the outstanding principal on that loan.

(5) *Standard representations and warranties* mean contractual provisions that a savings association extends when it transfers assets (including loan servicing assets) or assumes when it purchases loan servicing assets. To qualify as a standard representation or warranty, a contractual provision must:

(i) Refer to facts that the seller or servicer can verify, and has verified with reasonable due diligence, prior to the time that assets are transferred (or servicing assets are acquired);

(ii) Refer to a condition that is within the control of the seller or servicer; or

(iii) Provide for the return of assets in the event of fraud or documentation deficiencies.

(6) *Traded position* means a recourse obligation, direct credit substitute, or asset- or mortgage-backed security that is retained, assumed or issued in connection with an asset securitization, and that was rated with a reasonable expectation that, in the near future:

(i) The position would be sold to investors relying on the rating; or

(ii) A third party would, in reliance on the rating, enter into a transaction such as a loan or repurchase agreement involving the position.

Dated: September 3, 1997.

By the Office of Thrift Supervision.

Nicolas P. Retsinas,

Director.

[FR Doc. 97–28828 Filed 11–4–97; 8:45 am]

BILLING CODES: 4810–33–P, 6210–01–P, 6714–01–P, 6720–01–P

DEPARTMENT OF THE TREASURY

Office of the Comptroller of the Currency

12 CFR Part 3

[Docket No. 97–22]

RIN 1557–AB14

FEDERAL RESERVE SYSTEM

12 CFR Parts 208 and 225

[Regulations H and Y; Docket No. R–0985]

FEDERAL DEPOSIT INSURANCE CORPORATION

12 CFR Part 325

RIN 3064–AB31

DEPARTMENT OF THE TREASURY

Office of Thrift Supervision

12 CFR Part 567

[Docket No. 97–86]

RIN 1550–AB11

Risk-Based Capital Standards; Recourse and Direct Credit Substitutes; Correction

AGENCIES: Office of the Comptroller of the Currency, Treasury; Board of Governors of the Federal Reserve System; Federal Deposit Insurance Corporation; and Office of Thrift Supervision, Treasury.

ACTION: Joint notice of proposed rulemaking; correction.

SUMMARY: The Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision (collectively, the agencies) are issuing a correction to its joint notice of proposed rulemaking published on November 5, 1997 to clarify three of the tables contained in the preamble to the rule. The proposed rule would revise the agencies' risk-based capital standards to address recourse and direct credit substitutes.

FOR FURTHER INFORMATION CONTACT: Mary H. Gottlieb, Office of Thrift Supervision, (202) 906–7135; or any of the persons listed in the joint notice of proposed rulemaking.

SUPPLEMENTARY INFORMATION: On November 5, 1997, the agencies published a joint notice of proposed rulemaking concerning recourse and direct credit substitutes. 62 FR 59944 (November 5, 1997). It has been determined that three of the tables appearing in the preamble at 62 FR 59958–59959 are in need of clarification. These tables, entitled "Residential Mortgage-Backed Securities," "Asset-Backed Securities," and "Commercial Mortgage-Backed Securities," are being reprinted in their entirety at the end of this correction document.

Dated: November 10, 1997.

Jessie Gates,

Federal Register Liaison, Office of the Comptroller of the Currency.

By order of the Board of Governors of the Federal Reserve System, November 10, 1997.

Barbara R. Lowrey,

Associate Secretary of the Board.

Dated at Washington, D.C., this 12th day of November, 1997.

Federal Deposit Insurance Corporation.

Robert E. Feldman,

Executive Secretary.

Dated: November 7, 1997.

By the Office of Thrift Supervision.

Mary H. Gottlieb,

Federal Register Liaison Officer.

The corrected tables follow:

BILLING CODE 4810–33–P, 6210–01–P, 6714–01–P, 6720–01–P

Residential Mortgage-Backed Securities

Pool Type[1,2]	"Rating Benchmark" Prior Credit Enhancement Required for "A" Rating	Pool Standards
30-year loans	1.6 percent	Pools include at least 400 loans for each pool type. No borrower concentration over 3 percent for each pool type.
15-year loans	0.8 percent	
Adjustable Rate Mortgages (ARMs) (1,5), (2,6)	2.4 percent	
Hybrid loans (fixed-to-variable)	2.4 percent	
Balloon loans	2.0 percent	
	For no documentation and reduced documentation loans, multiply the above enhancements by 2. For condominiums, two-to-four family, and cooperative apartments, multiply the above enhancements by 2. For B and C loans, multiply the above enhancements by 3. For loan-to-value (LTV) ratios equal to or below 80 percent: -- Use above enhancements. -- Multiply above enhancements by 2, if there is private mortgage insurance (PMI) that brings loans below 80 percent. For LTV ratios above 80 percent, multiply the above enhancements by 4. For the first five years of the securitization, the above enhancement requirement, as a percentage of the outstanding principal, remains fixed. For years six through ten, the enhancement requirement would be multiplied by 0.75. Beyond ten years, the enhancement would be multiplied by 0.5[3,4].	

1 For positions that represent less than 10 percent of the size of the underlying pool of loans, add 20 percent to the enhancement level.

2 For closed-end second mortgage securities, determine the LTV ratio of the loans in the security and apply the enhancement requirements for the underlying collateral. In addition, change the 15-year enhancement requirement to 1.6 percent due to increased risk of security.

3 The reduction in the muliplier over time reflects the reduced risk of the mortgage portfolio due to seasoning.

4 For a six-year old 15-year mortgage-backed security backed by B and C loans that have LTV ratios above 80 percent, the enhancement would be 0.8 percent x 3 x 4 x 0.75 = 7.2 percent.

Asset-Backed Securities

Pool Type[1]	"Rating Benchmark" Prior Credit Enhancement Required for "A" Rating	Pool Standards
Credit Cards[2]	The higher of 6 percent or 1.2 times lagged charge-off rate[3].	Enhancement has access to excess spread.
Auto Loans Prime (A type) Sub-prime (B, C, and D types)	 7.0 percent The higher of 15.0 percent or 3 times net expected loss rate[4].	Sellers of automobile loans must have at least three years of historical information. Enhancement has access to excess spread.
Trade Receivables	12.0 percent per loan pool[5] (if all sellers of trade receivables are rated 1or 2) 18.0 percent per loan pool[5] (if any seller of trade receivables is rated 3 or 4 and no lower than 4)	Pools may not have seller concentrations above 5 percent of pool amount. Based on Federal Reserve Board rating criteria for trade receivables, each seller must be rated between 1 and 4.
	All of the above enhancements will remain fixed as a percentage of outstanding principal, with a floor of 3 percent of original principal.	For credit cards and auto loans, pool must be randomly selected and nationally-diversified.

1 For positions that represent less than 10 percent of the size of the underlying pool of loans, add 20 percent to the credit enhancement level.
2 Credit cards include home equity lines of credit that are similar to credit card loans.
3 Lagged charge-off rate is based on the monthly average of past six month's charge-offs, multiplied by twelve, then divided by the average outstanding balance from a year ago.
4 Net expected loss rate is the monthly average of last quarter's gross default amount netted against recoveries, multiplied by twelve, then divided by the average outstanding loan balance for the last quarter.
5 Overcollateralization amount would count toward credit enhancement.

Commercial Mortgage-Backed Securities

Pool Type[1]	"Rating Benchmark" Prior Credit Enhancement Required for "A" Rating	Pool Standards
Office	26.0 percent	Debt-service coverage at least 1.25
Regional Mall	10.0 percent	Debt-service coverage at least 1.35
Industrial/Anchored Retail	13.0 percent	Debt-service coverage at least 1.35
Multifamily	17.0 percent	Debt-service coverage at least 1.25
	The above enhancements are for pools of loans with loan-to-value ratios less than or equal to 70 percent. For pools of loans with greater than 70 percent loan-to-value ratio, multiply the above enhancements by 1.5. For pools with property quality below the B level, multiply the above enhancements by 1.5. The above enhancements will remain fixed as a percentage of outstanding principal, with a floor of 3 percent of original principal.[2]	For each type of pool above: -- No borrower concentration over 5 percent of pool amount. -- The amortization schedule does not exceed 25 years.

1 For positions that represent less than 10 percent of the underlying pool of loans, add 20 percent to the credit enhancement level.

2 For example, the enhancement for a security containing regional mall loans with an 80 percent LTV ratio and B quality property would be 10 percent x 1.5 x 1.5 = 22.5 percent.

[FR Doc. 97–30544 Filed 11–19–97; 8:45 am]

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